Chapter 6: Agricultural Issues and Rural Investments

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Corrections were made to this workbook through January of 2014. No subsequent modifications were made.

AGRICULTURAL TAX CHANGES FROM ATRA

The American Taxpayer Relief Act of 2012 (ATRA) makes permanent key parts of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). For example, EGTRRA expanded the individual income tax brackets, but the expansion was set to expire on a certain date, which Congress extended several times. ATRA made the expanded tax brackets permanent. ATRA also permanently increases the alternative minimum tax (AMT) exemption. These changes and other provisions of ATRA are very taxpayer-friendly.

Although some analysts had anticipated that Congress would extend the 2% rate reduction in the employee's portion of FICA taxes, the rate reduction was allowed to expire. As a result, all wage earners and self-employed persons who are subject to FICA taxes pay a higher rate in 2013 compared to 2011 and 2012.[1]

In addition to not extending the FICA rate reduction, ATRA also contains **significant tax increases.** These increases have a significant effect on taxpayers in the higher income ranges.

Note. ATRA is discussed more fully in the 2013 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Legislation. The discussion here highlights the parts of ATRA that are most important to taxpayers who are engaged in production agriculture or who are rural landowners.

HIGHER INCOME TAX RATE[2]

ATRA imposes a 39.6% rate on taxable income above the following amounts.

Filing Status	2013 Threshold
Married Filing Jointly (MFJ) or Qualified Widower (QW)	$450,000
Head of Household (HoH)	425,000
Single (S)	400,000
Married Filing Separately (MFS)	225,000

These thresholds are indexed for inflation for tax years beginning after 2013.

1. The employee's portion of FICA tax for 2013 increases from 4.2% to 6.2% and the self-employed tax rate increases from 10.4% to 12.4%. For a taxpayer with wage and/or self-employment income at or above the maximum wage base of $113,700 for 2013, an additional $2,274 in tax liability results from the rate increase.

2. IRC §1(i)(3).

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For taxpayers in the top bracket in 2013, the **marriage penalty** can be significant.

Example 1. Tom and Gail are married. For 2013, Tom has taxable farm income of $400,000 and Gail also has wage income of $400,000 from her job as a farm business consultant for the University of Illinois. After the deduction for half of self-employment (SE) taxes, the standard deduction, and allowed exemptions, their taxable income is $775,394.

Based on the 2013 tax rates, the couple will owe income tax of $254,702 and Medicare surtaxes of $4,950.

Using the same facts, if Tom and Gail were **not** married, their combined income tax would be $224,142 and the Medicare surtaxes would be $3,600. Thus, the marriage penalty is an additional $30,560 in income taxes for 2013 and an additional Medicare surtax of $1,350.[3] For Tom and Gail, the marriage penalty totals $31,910.

Note. The Medicare surtaxes were created as part of the Patient Protection and Affordable Care Act of 2010. The surtaxes are covered later in this chapter.

PHASEOUTS OF PERSONAL EXEMPTIONS AND ITEMIZED DEDUCTIONS

ATRA also increases taxes for taxpayers whose adjusted gross incomes (AGI) are not above the threshold for the new 39.6% rate. ATRA does this by reinstating the phaseouts of personal exemptions and itemized deductions. The exemption phaseout begins at the following thresholds.

Filing Status	Threshold
MFJ or QW	$300,000
HoH	275,000
Single	250,000
MFS	150,000

Once the applicable threshold is reached, the allowable deduction for exemptions drops by 2% for every $2,500 (or portion thereof) that the taxpayer's AGI exceeds the threshold.[4] For those filing as **MFS, the reduction is 2% for every $1,250** of income above the threshold amount.[5]

The same thresholds apply to the phaseout of itemized deductions.[6] Once the applicable AGI threshold is reached, itemized deductions are reduced by 3% of the taxpayer's AGI that exceeds the threshold, up to a maximum reduction of 80% of the otherwise allowable itemized deductions.

Note. Because the thresholds are lower for these provisions than those that apply to the beginning of the 39.6% rate, taxpayers with incomes less than the threshold for the beginning of the 39.6% rate will see an effective tax increase. The effective rate increase is 3% of the stated tax rate; thus, it is 1.188% for taxpayers in the 39.6% bracket and .99% for taxpayers in the 33% bracket.

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3. The example is courtesy of Paul Neiffer, CPA, in Spokane, Washington. Although modified slightly, it is based on an actual client situation.

4. IRC §151(d)(3). The phaseout range is $125,000 (i.e., $2,500 ÷ 0.02) for taxpayers other than those filing MFS and $62,500 for those filing MFS. The effective tax rate increase varies, depending on the number of personal exemptions claimed. Taxpayers filing as MFJ are fully phased out before being subject to the 39.6% bracket. For example, it is 4.37% for a taxpayer claiming 4 exemptions at the 35% rate.

5. IRC §§151(d)(3)(A) and 68(b)(2). This provision is indexed for inflation for tax years that begin after 2013.

6. IRC §§68(b) and (c). The phaseout is not applicable to itemized deductions for investment interest, medical expenses, casualty or theft losses, and gambling losses.

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INCOME TAXATION OF ESTATES AND TRUSTS

ATRA eliminates the 35% rate for the income of estates and trusts and replaces it with a 39.6% rate. The starting point for the new 39.6% rate is $11,950 for 2013.

> **Observation.** ATRA does not clearly address how the new 39.6% ordinary income tax rate and the 20% capital gain rate apply to trusts and estates. Section 101(b)(1)(B) of ATRA adds IRC §1(i)(3), which states that the rate of tax under subsections (a),(b), (c), and (d) increases from 35% to 39.6% for income above the "applicable threshold." Trusts and estates are not taxed under any of these subsections. Instead, they are taxed under IRC §1(e). In addition, ATRA does not provide any threshold amount at which the 39.6% bracket begins. Perhaps an argument can be made that ATRA simply reinstates the tax rates that were in effect before EGTRRA became effective, including the 39.6% rate.

Permanancy of Transfer Taxes

ATRA, effective for transfers after 2012, establishes a $5 million (inflation-adjusted) unified credit exemption equivalent for estate, gift and generation-skipping transfer tax (GSTT) purposes. For 2013, the inflation-adjusted amount is $5.25 million. The present interest annual exclusion for gift tax purposes is $14,000 for 2013. Portability of the unused amount of the exclusion at the death of the first spouse to die is also retained and made permanent.[7] However, the rate on transfers above the amount covered by the credit is increased from 35% to 40%. Specifically, under ATRA, transfers exceeding $500,000 are taxed at 37%, transfers over $750,000 are taxed at 39%, and transfers over $1 million are taxed at 40%. Thus, with the exemption equivalent of the credit set at $5.25 million for 2013, the unified credit for 2013 is $2,045,800.

> **Note.** Other EGTRRA transfer tax changes were made permanent. These include the repeal of the state death tax credit (it was replaced with a deduction), the repeal of the qualifying family-owned business (QFOB) deduction, modification of the qualified conservation easement donation rules, technical changes to the installment payment rules, and certain GSTT technical amendments. Stepped-up basis is retained.

SELECTED CORPORATE TAX PROVISIONS

2-Year Extension for Excluding 100% of Gain on Certain Small Business Stock

ATRA restores for 2012 and extends through 2013 the ability to exclude all of the gain on the sale of IRC §1202 stock. The stock must have been acquired after September 27, 2010. A 5-year holding period requirement must be satisfied and the corporation must be a C corporation during the holding period. Without additional legislation, the exclusion drops to 50% beginning January 1, 2014.

5-Year Recognition Period for S Corporation Built-in Gain (BIG) Tax

For tax years beginning in 2012 and 2013, ATRA provides a 5-year recognition period instead of a 10-year period for computation of any net recognized BIG. In addition, the provision specifies that if an installment sale is made after the recognition period (e.g., five years) and the recognition period reverts to 10 years, the gain on the installment sale is protected from the BIG tax. Also, if the BIG income is carried forward to future years due to the taxable income limitations and the BIG period has expired, no BIG tax applies to the expired amount. Further, a new provision states that if an S corporation sells an asset under the installment method, the treatment of all payments received are governed by this provision applicable to the tax year in which the sale was made.

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[7] With portability, the deceased spouse's unused exemption equivalent of the unified credit (the deceased spouse's unused exclusion amount) can be transferred by election to the surviving spouse. Form 706 must be filed for the estate of the first spouse to die, regardless of the size of the decedent's estate, to make the election. Portability applies only to the unused exemption of the decedent's last surviving spouse.

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DEPRECIATION PROVISIONS

Note. See the 2013 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues; and Volume A, Chapter 1: New Legislation for more information on ATRA changes to bonus depreciation and IRC §179.

Bonus Depreciation

First-year 50% bonus depreciation is extended for property placed in service through 2013 (through 2014 for certain "longer-lived" assets). The provision is based on the taxpayer's calendar year and applies to new property first placed in service by the taxpayer. The property must have a cost recovery period of no more than 20 years.[8] The provision applies to light trucks or vans, including SUVs, built on a truck chassis rated at 6,000 pounds loaded vehicle weight or less.

The ability to treat certain types of qualified real property (qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property) as 15-year MACRS property was retroactively reinstated for 2012 and extended through 2013. Because qualified leasehold improvement property was reinstated for 2012, it is eligible for 50% bonus depreciation if it is placed in service in 2012 or 2013 under the special rule that applies under the bonus provision.[9]

Note. Bonus depreciation is mandatory for eligible property unless an election out is made.[10] An election out is made on a class-by-class basis. Once the election is made, it is irrevocable. The election out of first-year bonus depreciation must be made by the due date (including extensions) of the tax return for the year in which the qualified property was placed in service (e.g., October 15 for calendar-year taxpayers).

Expense Method Depreciation

The IRC §179 deduction (expense method depreciation) was retroactively reinstated for tax years beginning in 2012 at $500,000 (with a $2 million investment ceiling) and is extended at that level for 2013.[11] Also extended for tax years beginning before 2014 is the ability to make or revoke an expense method depreciation election on an amended return for an open tax year.[12]

Note. If only a portion of an asset's basis was expensed and the election is later revoked on an amended return, any portion of the asset for which the expense method election was not claimed could still qualify to be expensed. In addition, if an election was originally made to expense a portion of that asset and then an election is made to expense a larger portion of the asset, the election to increase the expensed portion is not a deemed revocation of the original election for the asset. Therefore, the taxpayer can still revoke the election with respect to some or all of the asset. The ability to make or revoke an election on an amended return provides tremendous flexibility to make after-the-fact audit adjustment changes and retroactive tax planning for open tax years.

ATRA also reinstates for 2012 and extends through 2013 the ability to utilize expense method depreciation for up to $250,000 (as part of the overall limitation of $500,000) of qualified real property.[13]

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8. As applied to autos and trucks, the additional $8,000 deduction allowed for the placing in service of a new vehicle is extended through 2013. The $8,000 is added to the $3,160 first year "luxury" cap (2012 and 2013 amount).

9. All three categories qualify for up to $250,000 of IRC §179 depreciation, but only qualified leasehold improvement property qualifies for bonus depreciation. IRC §168(e)(6)(B).

10. IRC §168(k).

11. Expense method depreciation will drop to $25,000 beginning in 2014 without additional legislation.

12. Rev. Proc. 2008-54, 2008-38 IRB 722; CCA Information Letter 2009-0059 (Feb. 17, 2009). The IRS is successfully processing such returns, and IRS auditors are allowing the process of making, as well as revoking, an expense method depreciation election on an amended return in audit.

13. Such property includes qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.

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Factors to Consider

The following are reasons to consider not using accelerated methods of depreciation.

- As noted earlier, expense method depreciation is set to drop to $25,000 in 2014 and bonus depreciation is scheduled to sunset after 2013. Practitioners need to think strategically about future tax management with the goal of not necessarily eliminating income tax, but managing farm income such that the farm client is kept in the lowest possible tax bracket over the long term. Not maximizing depreciation in 2013 by using §179 or bonus depreciation could preserve additional depreciation deductions that can be used to offset income in future years. This will be a particularly good strategy if tax rates increase in the future.

Observation. If large depreciation deductions are claimed, it can be a good strategy to reduce prepaid expenses or increase sales of inventory in that year to help reduce taxable income in future years.

- The taxpayer may unexpectedly sell an asset (or assets) on which accelerated methods of depreciation have been claimed (including expense method depreciation and/or bonus depreciation). Such a sale can trigger significant amounts of depreciation recapture. As noted earlier, if an expense method depreciation election has been made on the property that is sold, the election can be revoked for open tax years. This can eliminate a significant amount of depreciation recapture. Also, if there is a possibility that the client might sell an asset that qualifies for bonus depreciation, an election out of bonus depreciation can be made.

  Relatedly, for assets on which first-year bonus depreciation has been taken, if business use of the asset drops to 50% or less in a subsequent year, the additional 50% first-year bonus depreciation amount is subject to recapture in the same manner as regular MACRS depreciation.[14]

Observation. Depreciation is recaptured upon the sale of an asset. Consequently, some taxpayers may think they can avoid claiming depreciation as a strategy to avoid depreciation recapture. This strategy does not work, because the tax law requires depreciation recapture to be calculated on depreciation that was "allowed or allowable."[15]

- For farm clients that participate in federal farm programs and receive either direct payments, counter-cyclical payments, or Commodity Credit Corporation (CCC) loans, an "excess farm loss" is subject to a limit on deductibility. Because the total deductions for the tax year from the farming business are part of the determination of an excess farm loss, accelerated depreciation can create a Schedule F loss that may be limited by the excess farm loss provision.

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14. IRC §168(k)(2)(F)(ii).

15. IRC §1250(b)(3).

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TAXES ON CAPITAL GAINS AND DIVIDENDS

Under ATRA, the top capital gain and dividend rate increases to 20% for taxpayers whose taxable incomes exceed the following thresholds.

Filing Status	Threshold
MFJ or QW	$450,000
HoH	425,000
Single	400,000
MFS	225,000

Note. The thresholds are the same for the new 39.6% tax bracket as for the higher capital gains and dividend tax rates. ATRA did not change the rates for taxpayers in lower brackets. The 0% capital gain rate is retained for taxpayers in the 10% and 15% brackets. The 15% rate is also retained on capital gains and dividends for taxpayers in the 25% to 35% brackets. In addition, the **maximum rate** for unrecaptured IRC §1250 depreciation is still 25% and the maximum rate for collectibles is still 28%.[16]

Note. Assets acquired from a decedent or property passed from a decedent (within the meaning of IRC §1014) automatically receive long-term holding period treatment when sold (either by the decedent's estate or a beneficiary).[17]

16. IRC §1(h).

17. IRC §1223(9).

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Example 2. Clay Tile is a single farmer with $600,000 of Schedule F, *Profit or Loss From Farming,* net income for 2013. In October 2013, he sells some farmland (including the unharvested crop) to Tom Tiller. The long-term capital gain on the sale totals $800,000. He also has $60,000 in itemized deductions composed of deductible interest and charitable donations.

If the facts were the same **except** that Clay sold the farmland and unharvested crop in **2012,** Clay would pay $59,883 less in income taxes than he would in 2013 because of the ATRA changes.[18]

	2012 Sale without ATRA	2013 Sale with ATRA
Schedule F net income	$ 600,000	$ 600,000
Long-term capital gain	800,000	800,000
Total income	$1,400,000	$1,400,000
Less: self-employment tax deduction	(14,859)	(15,084)
AGI	$1,385,141	$1,384,916
Less: allowed itemized deductions	(60,000)	(25,953)
Less: personal exemption	(3,800)	(0)
Taxable income	$1,321,341	$1,358,963
Total tax liability	$ 279,230	$ 339,113

Clay's higher total tax liability in 2013 is due to the following changes implemented by ATRA.

- The phaseout of itemized deductions
- The self-employment (SE) tax rate increasing to 15.3% from 13.3%
- The phaseout of personal exemptions
- The top tax bracket increasing to 39.6% from 35%
- The capital gains tax rate increasing to 20% from 15%

SALE OF FARMLAND WITH UNHARVESTED CROPS

Expenses related to the production of unharvested crops that are sold with the farmland on which they grow **are not deductible.**[19] However, these expenses **are added** to the basis of the land. When the crops are sold at the same time as the land and to the same person, the classification of any gain as short term or long term does not change.[20] This classification is based on the length of time that the land is owned.[21]

These Code provisions are a double-edged sword. If the land is held long term, the gain attributable to the unharvested crops is taxed at the lower capital gains tax rate. However, the deductions on Schedule F are reduced. Furthermore, if the production costs were deducted on a previous year's return, the taxpayer **must amend** the previous return to reduce expenses by the amount related to the unharvested crop.[22]

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18. This example is a modified version of an example contained in *Farm Tax and Farm Sales Affected by New Fiscal Cliff Legislation.* Lovell, Marc. Feb. 7, 2013. Department of Agricultural and Consumer Economics, University of Illinois. [http://farmdocdaily.illinois.edu/2013/02/farm-tax-and-farm-sales-affected.html] Accessed on Jul. 17, 2013.

19. IRC §268 specifies that when an unharvested crop is considered to be property used in the trade or business of farming under IRC §1231, no deduction attributable to the production of the crop is allowed.

20. IRC §1231(b)(4).

21. IRC §1231 specifies that the gain from the sale of IRC §1231 property (property that has been held for more than one year) is treated as long-term capital gain. Also, any loss on IRC §1231 property is treated as an ordinary loss. This treatment is mandatory under IRC §1231(b)(4).

22. Treas. Reg. §1.268-1.

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Example 3. Use the same facts as **Example 2.** Clay's basis in the sale includes $100,000 of prepaid expenses that he deducted on his 2012 income tax return.

Clay must amend his 2012 return and reduce his Schedule F expenses by this $100,000. The amended Schedule F must show a negative amount on line 32 (other expenses) that reverses the $100,000 of the crop expense deductions that were claimed on the original return. For his amended return, he owes $37,210 in taxes, plus any applicable interest.

The $100,000 included in the basis of the 2013 land sale reduces Clay's 2013 federal income taxes and additional Medicare tax by $24,988. The net effect is that Clay pays an additional $12,222 ($37,210 – $24,988) in taxes by selling the unharvested crop with the land.

If the taxpayer retains a right or option to reacquire the farmland, the unharvested crop is not treated as being sold with the land. Therefore, the sale of the unharvested crop is not treated as part of a sale of business assets under IRC §1231. However, this rule does not apply to incidental rights held under a mortgage.[23]

Example 4. Use the same facts as **Examples 2 and 3,** except Clay sells the land to Tom but reserves the right to harvest the crop in 2013 and sell it whenever he pleases. Because of this provision, he sells the land for $200,000 less than he did in **Example 2.** His basis is also $100,000 less than in **Example 2** because the crop production costs are not included in the land basis.

His new gain is calculated as follows.

Original gain from sale of land with unharvested crops	$800,000
Less: reduction in selling price	(200,000)
Plus: reduction in basis	100,000
Revised gain from sale of land only	$700,000

The revised circumstances provide Clay with more flexibility for income tax planning. Clay **is not required** to amend his 2012 return. If he waits until 2014 to sell the crop, the crop income will not be reported in the same year as the capital gain.

Observation. To avoid the application of IRC §1231, Clay could **sell the land** to Tom under one contract and **sell the crop** to Tom under a different contract. Under the crop contract, Clay could reserve the right to harvest the crop and sell it. Utilizing separate contracts for the land and the unharvested crop can provide Clay with flexibility to avoid any potential negative impact of IRC §1231 and allow Clay to offset ordinary income from the sale of the crop by the amount of production expenses. Alternatively, as noted earlier, Clay could retain a right to reaqcuire the property or sell less than a complete ownership interest in the farmland to avoid the application of IRC §1231.

23. Treas. Reg. §1.1231-1(f).

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MEDICARE SURTAXES

Note. For more information on the Medicare surtaxes, see the 2013 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: Affordable Care Act Update.

The Patient Protection and Affordable Care Act of 2010 (ACA) contains numerous tax provisions that are phased in over time. Effective January 1, 2013, the ACA implements two new Medicare surtaxes.

1. A **0.9% surtax on earned income** above certain thresholds based on filing status[24]
2. A **3.8% surtax on net investment income** above certain thresholds based on filing status[25]

THE ADDITIONAL MEDICARE SURTAX ON EARNED INCOME

The 0.9% surtax on earned income is called the additional Medicare tax. It applies to wages and SE income that exceed the following threshold amounts.

Filing Status	Threshold
MFJ or QW	$250,000
HoH	200,000
Single	200,000
MFS	125,000

There is no employer match on the 0.9% additional Medicare tax. The tax is entirely on the employee share, although **the employer must withhold the tax on wages that exceed $200,000.**[26] The employer is subject to penalties for any failure to withhold and properly pay the tax.

If a married couple has wages from multiple employers and the wages do not exceed the $200,000 threshold from any one employer, they will not have any additional Medicare tax withheld. However, if the total wages for the year exceed the applicable threshold on a joint return, the additional Medicare tax applies. Because an employer only needs to withhold when an employee's wages exceed $200,000, the additional Medicare tax will have to be remitted via Form 1040.

24. IRC §§3101(b)(2) and 1411(a)(1).
25. IRC §1411.
26. IRC §3102(f).

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Implications of the Additional Medicare Tax for Farmers

There are several important points that self-employed farmers should be aware of concerning the additional Medicare tax.

1. Because the additional Medicare tax only applies to the employee share, a self-employed taxpayer is **not** permitted to claim an income tax deduction for the tax.[27] The self-employed deduction for the equivalent of the "employer's half" of the SE tax remains at 7.65%.
2. Wages paid in-kind with commodities are not taxable wages for additional Medicare tax purposes.[28] Thus, no additional withholding is required for in-kind wages. In-kind wages are also not subject to SE tax.
3. A significant marriage penalty may apply to farmers whose spouses also have earnings subject to the additional Medicare tax if the couple's combined earnings exceed $250,000.
4. For farmers who materially participate in a partnership that has trade or business income, their share of income from the partnership is SE income potentially subject to the 0.9% tax.
5. Farmers who have employees who earn in excess of $200,000 are liable for withholding the additional Medicare tax from the employee's wages.

Note. An additional line has been added to the 2013 Form 941, *Employer's Quarterly Federal Tax Return,* to report the additional 0.9% Medicare tax. Form 943 is used by agricultural employers to report the social security and Medicare taxes on wages paid to farmworkers.

Example 5. Phineas Farm, Inc., has one employee who was paid $240,000 in 2013. Phineas's completed Form 943 follows.

Form **943** — **Employer's Annual Federal Tax Return for Agricultural Employees** — OMB No. 1545-0035 — 2013

Department of the Treasury
Internal Revenue Service

▶ Information about Form 943 and its separate instructions is at *www.irs.gov/form943.*

Type or Print

Field	Entry
Name (as distinguished from trade name)	Phineas Farm, Inc.
Employer identification number (EIN)	36-1234567
Trade name, if any	
Address (number and street)	123 East Easy Street
City or town, state or province, country, and ZIP or foreign postal code	Pottstown IL 61619

If address is different from prior return, check here. ▶ ☐

If you do not have to file returns in the future, check here . . . ▶ ☐

DRAFT AS OF July 23, 2013 DO NOT FILE

Line	Description		Amount
1	Number of agricultural employees employed in the pay period that includes March 12, 2013 ▶	1	1
2	Total wages subject to social security tax	2 113,700	
3	Social security tax (multiply line 2 by 12.4% (.124))	3	14,099
4	Total wages subject to Medicare tax	4 240,000	
5	Medicare tax (multiply line 4 by 2.9% (.029))	5	6,960
6	Total wages subject to Additional Medicare Tax withholding	6 40,000	
7	Additional Medicare Tax withholding (multiply line 6 by 0.9% (.009))	7	360
8	Federal income tax withheld	8	48,000
9	Total taxes before adjustments. Add lines 3, 5, 7, and 8	9	69,419
10	Current year's adjustments	10	
11	Total taxes after adjustments (line 9 as adjusted by line 10)	11	69,419
12	Total deposits for 2013, including overpayment applied from a prior year and Form 943-X	12	69,419
13a	COBRA premium assistance payments	13a	0
13b	Number of individuals provided COBRA premium assistance	13b	
14	Add lines 12 and 13a	14	69,419
15	**Balance due.** If line 11 is more than line 14, enter the difference and see the instructions ▶	15	0

...**nt.** If line 14 is more than line 11, enter the diff... ▶ $ ... Check one: ☐ Apply to ... ☐ Send a ...

[27] IRC §164(f)(1).

[28] IRC §§3101(b)(1) and 3121(a)(8)(A).

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THE ADDITIONAL MEDICARE SURTAX ON PASSIVE INCOME

Effective January 1, 2013, the ACA imposes a new 3.8% Medicare surtax on the **net investment income** (NII) of higher-income individuals. The surtax is called the net investment income tax (NIIT).

> **Note.** The 3.8% surtax is not deductible. In addition, self-employed persons cannot claim the surtax as part of the deductible portion of SE taxes under IRC §164(f).

The NIIT is 3.8% of the lesser of the following.

1. NII for the year
2. The amount of the taxpayer's modified adjusted gross income (MAGI)[29] that exceeds the applicable threshold

The thresholds for this tax are the same as those used for the additional Medicare tax.

Implications of the NIIT for Farmers

> **Note.** The calculation of NII is explained in detail in the 2013 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: Affordable Care Act Update.

1. Capital gains and other net gains from the disposition of real property are generally included in NII. There is an exception for the portion of the gain attributable to property used in an activity in which the taxpayer materially participated.[30] Farmers qualify as materially participating if they materially participated in the farming operation for at least five years in the 8-year period preceding their retirement or disability.[31] If the farmer satisfies this test, the gain from the sale of farm property is **excluded from NII regardless** of when the property is actually sold.
2. Capital gains from the sale or liquidation of a closely held C corporation are included in NII, even if the taxpayer materially participated in the corporation.

Example 6. Frank Furrow conducts his farming business through his C corporation. Frank materially participates in the farming corporation.

In 2013, Frank sells the stock of the C corporation and realizes a $1.5 million gain. To the extent Frank's AGI exceeds the applicable threshold, the $1.5 million gain is subject to the 3.8% NIIT.

3. NII does **not** include gains from the disposition of an interest in a partnership or S corporation in which the taxpayer materially participates.[32]

> **Note.** The liquidation of an S corporation that was converted from a C corporation **after the expiration of the built-in gain recognition period** may not be subject to the NIIT if the taxpayer materially participated in the S corporation.

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29. IRC §1411(d). MAGI is equal to AGI increased by any foreign earned income exclusion and reduced by any deductions allowed against the foreign earned income.
30. IRC §1411(c)(1)(A).
31. Instructions for Schedule F.
32. IRC §1411(c)(4).

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Example 7. Pete Moss is single. He formed a farm corporation several years ago for his farming operation. In 2013, Pete received $190,000 in salary and $110,000 of cash rental income from his corporation. Pete's AGI for 2013 is $300,000. Pete is subject to the 3.8% NIIT on the smaller of his net rental income ($110,000) or his MAGI in excess of the $200,000 threshold ($100,000). Pete incurs the tax on $100,000 ($300,000 MAGI – $200,000 threshold). Thus, Pete will incur $3,800 of NIIT in 2013.

Business Income — Material Participation. Income derived from a business in which the taxpayer does not materially participate on a basis that is regular, continuous, and substantial is deemed to be passive for purposes of the 3.8% NIIT. In determining whether a taxpayer materially participates in a business activity, the tests established under the passive loss rules of IRC §469 are utilized. Under those rules, material participation in non-real estate activities is achieved if the taxpayer:[33]

1. Participates in the activity at least 500 hours during the tax year;
2. Participates in multiple activities in which the taxpayer participates at least 100 hours in each activity and has a total of at least 500 total hours in all of the activities;
3. Participates at least 100 hours and participates in the activity more than anyone else;
4. Is the only participant during the tax year;
5. Materially participated in five of the past 10 years or in any three years with respect to a personal service activity; or
6. Based on the facts and circumstances, is deemed to have materially participated.

Real estate rentals are always deemed passive unless extraordinary personal services are provided. For real estate professionals, however, the normal material participation tests set forth above apply. A real estate professional is someone who spends a majority of their time in real estate activities and puts in at least 750 hours in real property development, construction, acquisition, conversion, operation, management, leasing, or brokerage trade.

Grouping Election

Farmers who materially participate in a farming operation may also have income from other activities in which they do not materially participate. If the other activities are related to the farming operation, a grouping election can be made so that all of the activities are treated as a single activity. As a group, the combined income from the activities is **not** subject to the NIIT.[34]

Example 8. George's farming business is conducted through his S corporation. George is an employee of the S corporation and participates full time in the farming activities of the corporation. The corn raised on the farm is sold to an ethanol plant, which is also an S corporation. George has an ownership interest in the ethanol plant but does not participate in any of the ethanol plant's activities.

George's share of the net income from the ethanol plant is passive income to George. However, George makes a grouping election to treat the two S corporations as a single activity. This election allows him to treat the income from the ethanol plant as though he also materially participates in that business because he does materially participate in the related farming activities. Consequently, George's income from the ethanol plant is **not** subject to the NIIT.

A taxpayer who is a **limited** partner or **limited** entrepreneur[35] in a farming operation may not group that entity with any nonfarm activities. In addition, any farming group must still be an **appropriate economic unit.**[36]

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33. Temp. Treas. Reg. §1.469-5T.

34. Treas. Reg. §1.469-4(c).

35. Treas. Reg. §1.469-4(d)(3)(i) references the definition of a limited entrepreneur in IRC §464(e)(2), which defines the term as a person who (1) has an interest in an enterprise other than as a limited partner, and (2) does not actively participate in the management of such enterprise.

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Proposed Regulations Concerning the Grouping Election. Regulations describe the proper process for determining whether activities can be grouped into an appropriate economic unit for purposes of the application of passive activity limitations.[37] These regulations specifically allow businesses and rental activities to be grouped together if the facts and circumstances demonstrate that the grouping is appropriate.

However, the proposed regulations for the NIIT take the position that grouping a rental activity with a material participation business does **not** convert the rental income into material participation income for purposes of the NIIT.[38] This is true even if the grouping constitutes an appropriate economic unit.

If the proposed regulations are finalized, it will not be possible to avoid the 3.8% NIIT on rental income by making a grouping election. However, self-rental losses will be allowed to reduce NII because the passive activity limitations will not apply in determining net rental income.

The proposed regulations allow taxpayers to make a **one-time election** to change an existing grouping for the tax year in which the taxpayer is first subject to the NIIT. The determination that a taxpayer is subject to the tax is made before the activities are regrouped. Therefore, it is possible to use the new grouping to avoid the NIIT. Once the election is made, the new grouping **applies to all future tax years.**[39]

Application of the NIIT to Trusts and Estates

As applied to trusts and estates, the NIIT is **3.8% of the lesser** of the following.

1. Undistributed NII for the tax year
2. The amount of AGI for the tax year in excess of the amount at which the highest tax bracket begins for the tax year[40] (For 2013, the highest rate applies to trusts and estates with income over $11,950.)

Example 9. Peter and his wife Ellen had marital deduction wills prepared as part of their estate plan. Upon Peter's death, a trust created under his will took effect. The trust holds farmland for the period that Ellen survives Peter. The terms of the trust do not require annual income to be paid annually to Ellen.

The trust's net rental income from the farmland is $100,000 in 2013. The trust does not distribute any of the income for 2013. The NIIT is calculated as follows.

AGI	$100,000
Less: the threshold for the top income tax bracket	(11,950)
NII subject to the NIIT	$ 88,050
Tax rate	× 3.8%
NIIT	$ 3,346

Observation. If beneficiaries of a trust or estate are not subject to the NIIT or the top individual income tax rate, the fiduciary of the trust or estate should be advised to distribute the amount of the trust's or estate's AGI that exceeds the threshold for the top rate. Amounts paid or credited within the first 65 days of the tax year may be treated as paid on the last day of the prior tax year.[41]

36. Treas. Reg. §1.469-4(d)(3)(ii), Example (ii).
37. Treas. Reg. §1.469-4.
38. See Preamble, REG-130507-11 (Dec. 5, 2012). [www.gpo.gov/fdsys/pkg/FR-2012-12-05/pdf/2012-29238.pdf] Accessed on Jul. 20, 2013.
39. Prop. Treas. Reg. §1.469-11(b)(3)(iv). Any regrouping must be disclosed in accordance with Treas. Reg. §1.469-4(e) and other regrouping rules. See also Rev. Prov. 2010-13, 2010-4 IRB 329.
40. IRC §1411(a)(2).
41. IRC §663(b).

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Although IRS regulations set forth several material participation tests for individual taxpayers, the IRS has never issued regulations addressing the material participation requirement for nongrantor trusts or estates. For purposes of the passive loss rules, the Code defines a taxpayer as "any individual, estate, or trust."[42] Thus, although the statute is clear that a trust is the taxpayer whose material participation is decisive, the statute is silent on how to determine whether the test has been satisfied for a nongrantor trust.

Because a trust can only satisfy the material participation test through the actions of people, it is important to know who the key people are whose activity counts for purposes of the material participation test. On this point, the IRS recently issued a private letter ruling,[43] which concluded that **only the trustee** of a trust can satisfy the material participation test. According to the IRS, for the trust to materially participate in an activity, the trustee must participate in the trust's business on a regular and continuous basis **while acting in the fiduciary capacity as trustee.**

Observation. As a result of the IRS position, it will likely be impossible for a nongrantor trust with undistributed earnings to avoid the NIIT on passive sources of income.

Note. For more information on trusts and material participation, see the final section in this chapter.

Planning Strategies

In general, any strategy that reduces NII or MAGI helps reduce or eliminate the 3.8% NIIT. Strategies to consider include the following.

1. Increasing tax-exempt municipal bond investments
2. Maximizing qualified retirement plan contributions
3. Avoiding spikes in farming income

Using an LLC to Reduce SE Tax and the NIIT. Under proposed regulations, an LLC member has SE tax liability if:

1. The member has personal liability for the debts or claims against the LLC by reason of being a member,
2. The member has authority under the state's LLC statute to enter into contracts on behalf of the LLC, or
3. The member participated in the LLC's trade or business for more than 500 hours during the LLC's tax year.[44]

The LLC could be structured as a manager-managed LLC with two membership classes as a means of minimizing SE tax. The income of a member holding a manager's interest is subject to SE tax. However, if nonmanagers who participate less than 500 hours in the LLC's business hold at least 20% of the LLC interests, then any nonmanagers who participate more than 500 hours in the LLC's business are not subject to SE tax on the pass-through income from their LLC interest.[45] They do, however, have SE tax on any guaranteed payments.

It is possible to utilize a manager-managed LLC with the taxpayer holding both manager and nonmanager interests that can be bifurcated. The result is that an individual who holds both manager and nonmanager interests is not subject to SE tax on the nonmanager interest but is subject to SE tax on the pass-through income and guaranteed payments attributable to the manager interest.

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42. IRC §469(a)(2).

43. Ltr. Rul. 201317010 (Jan. 18, 2013).

44. Prop. Treas. Reg. §1.1402(a)-2(h)(2).

45. Prop. Treas. Reg. §§1.1402(a)-2(h)(4) and 1.1402(a)-2(h)(6)(iv).

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Example 10. Bob and Mary, a married couple, operate their farming business as an LLC. Mary works full-time as a nurse and is not involved in the farming operation. She does, however, have a 49% nonmanager ownership interest in the LLC. Bob works on the farm and has a 49% nonmanager interest along with a 2% manager interest. Bob receives a guaranteed payment for his manager interest that equates to reasonable compensation for his services to the LLC. The result is that the LLC's income is shared pro rata according to the ownership percentages, and **the income attributable to the nonmanager interests is not subject to SE tax.**[46]

If the farming business is structured as an LLC, a nonmanager's interest in a managed LLC is typically considered passive, with the income from the interest potentially subject to the NIIT. However, an individual can take into account the material participation of a spouse who is the manager.[47] Thus, the material participation of the manager-spouse converts the income attributable to the nonmanager interest of the other spouse from passive to active income that is not subject to the NIIT.

Observation. In **Example 10,** the end result is that SE tax is significantly reduced (15.3% percent of Bob's reasonable compensation in the form of a guaranteed payment) and the NIIT is avoided on Mary's income. This structure may provide a better overall tax result than the use of an S corporation with land rental income because of the ability to not only reduce SE tax but also to eliminate the NIIT.

FARM NET OPERATING LOSSES

Note. See the 2013 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues; and IRS Pub. 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts,* for more information on calculating an NOL and the carryforward rules.

If deductible farm expenses exceed farm income for the tax year, an **operating loss** results. The amount of the deductible loss can, however, be limited by the at-risk limits and the passive activity loss limits.[48] If a deductible loss remains after application of these rules and the loss is more than the taxpayer's other income, the taxpayer may have a net operating loss (NOL). Special rules apply to farm NOLs.

A farmer may have a farm NOL and a nonfarm NOL. An NOL and the farm loss may not be equal due to discrepancies in income and expense items used to calculate each.

The NOL is calculated using Schedule A-NOL of Form 1045, *Application for Tentative Refund.* Once it is determined that the taxpayer has an NOL for the tax year, any farm portion of the NOL must be separated from any nonfarm portion. A farming loss is defined as the **lesser** of the following.

1. The amount that would be considered the NOL for the tax year if only the income and deductions attributable to the farming businesses were taken into account
2. The NOL for that tax year[49]

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46. Adapted from an example prepared by Paul Nieffer, CPA, with CliftonLarsonAllen of Yakima, Washington, for use in Summer 2013 seminar materials for the Center for Agricultural Law and Taxation at Iowa State University.

47. IRC §469(h)(5).

48. For more information, see IRS Pub. 925, *Passive Activity and At-Risk Rules*.

49. IRC §172(j)(1). In addition, a farming loss does not include any loss that meets the definition of a pre-2010 qualified disaster loss.

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For this purpose, a **farming business** means a trade or business involving cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. A farming business can include operating a nursery or sod farm or raising or harvesting most ornamental trees or trees bearing fruit, nuts, or other crops. In addition, the raising, shearing, feeding, caring for, training, and management of animals is also considered a farming business. However, a farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by someone else. It also does not include a business in which the taxpayer merely buys or sell plants or animals grown or raised entirely by someone else.

CARRYFORWARD/CARRYBACK RULES FOR FARM NOLS[50]

A **farm NOL** can be:

1. Carried back five years;
2. By election, carried back two years; or
3. By election, carried forward until the earliest of 20 years or the year that the NOL is completely absorbed.

Once made, the elections are irrevocable. NOLs that are carried back are carried to the earliest of the applicable years. If the NOL is not used up, it is then carried to the next earliest carryback year, and so on, until the NOL is fully absorbed.

The default treatment of the farm NOL is to carry it back five years. Only the portion of the NOL attributable to the farming loss is included in the 5-year carryback.

To carry the NOL back **two years,** a statement must be attached to a timely filed (including extensions) tax return that specifies that an election is being made to treat any farming loss without regard to the special 5-year carryback rule.

To forgo both the 2- and the 5-year carrybacks, an election must be made by the due date of the return (including extensions). The election is made by attaching a statement to the original return for the NOL year that declares that the taxpayer is choosing to waive the carryback period under IRC §172(b)(3).

> **Note.** If the original return was timely filed but it did not include one of the statements previously described, an amended return can be filed with the necessary statement attached. The amended return must be filed within six months after the due date of the return, **excluding** extensions. The top of the attached statement should say: "Filed pursuant to section 301.9100-2." Once made, this election is irrevocable.

50. IRS Pub. 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts.*

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UNIQUE LOSS SITUATIONS FOR FARMERS

There are several aspects to NOLs that farmers and their tax advisors should consider.[51]

1. Schedule F deductions that give rise to an NOL may have the impact of failing to reduce SE tax. Deductions taken to reduce net farm income that do not create a loss serve to reduce SE tax. However, deductions taken to create an NOL do not reduce SE tax when the NOL is utilized in a different year.

2. An NOL carryback is applied to the actual taxable income of the year to which the carryback is applied. If an income averaging election was made for the carryback year, this does not affect the amount of NOL absorbed by that year.[52]

3. For the year an income averaging election is made, the taxable income still includes the amounts used in the income averaging calculation. Likewise, when calculating income tax using the income averaging method, the prior years' taxable incomes take into account all deductions, including NOLs carried over to those years.[53] However, any NOLs that carried back or forward from other years are added back into taxable income for each applicable tax year in the calculation.[54]

4. An NOL can be created by organizational restructuring of the farm business during the year. For example, if a sole proprietor farmer incorporates during the tax year after the expenses of planting the crop are incurred but before the crop is sold, the farmer may show an NOL for the year. However, the IRS can reallocate the expenses to the corporation to clearly reflect the taxpayer's income for the year.[55] The courts, in turn, have the power to reverse the IRS's reallocation if they find that the taxpayer has a reasonable explanation for the original allocation.[56]

5. A farm loss that exceeds other income results in negative taxable income that must be recomputed by adding back personal and dependency deductions to the extent they exceed nonbusiness income, and by adding back capital losses to the extent they exceed capital gains. If recomputed taxable income is positive, it does not trigger an NOL, but if it is negative, an NOL results.

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51. For further elaboration of these situations, see *Choices for Your Farm Operating Loss*. Patrick, George F. Aug. 2010. Rural Tax Education. [http://ruraltax.org/files/uploads/NOL Final Draft.pdf] Accessed on Aug. 9, 2013.

52. Treas. Reg. §1.1301-1(d)(1)(i).

53. Treas. Reg. §1.1301-1(d)(2)(i).

54. A worksheet is included with the Schedule J instructions to aid in the calculation.

55. IRC §482. See, e.g., *Central Cuba Sugar Co. v. Comm'r,* 198 F.2d 214 (2d Cir. 1952), *cert. den.,* 344 U.S. 874 (1952); *Rooney v. Comm'r,* 305 F.2d 681 (9th Cir. 1962).

56. See, e.g., Ltr. Rul. 7924003 (Feb. 26, 1979); *Fanning v. U.S.,* 568 F.Supp.823 (D. Wash. 1983); *Heaton v. U.S.,* 573 F.Supp. 12 (D. Wash. 1983).

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Farm Bill Provision

As a result of a provision included in the 2008 Farm Bill that is effective for tax years beginning after 2009, a farmer's losses can potentially be subject to a limitation.[57] An "excess farm loss" is disallowed.

An **excess farm loss** is defined as the amount of the taxpayer's aggregate deductions for the tax year that is attributable to the taxpayer's farming business (determined without regard to whether the deductions are disallowed for the tax year under IRC §461(j)(1)), in excess of the **sum** of:

1. The taxpayer's aggregate gross income or gain for the tax year that is attributable to the taxpayer's farming business, plus
2. The threshold amount for the tax year, which is the greater of:
   a. $300,000 ($150,000 for MFS taxpayers), or
   b. Total net farm income for the past five years. [58]

Note. When calculating aggregate deductions for purposes of determining an excess farm loss, any deduction for a loss arising from fire, storm, or other casualty or by reason of drought, involving any farm business, is not taken into account.[59] The instructions to Schedule F contain worksheets that can be used to compute any excess farm loss.

The provision only applies if the farmer receives any direct or counter-cyclical payments under Title 1 of the 2008 Farm Bill, or if the farmer receives a CCC loan. The provision applies to a "farming business," which is defined to include the processing of commodities irrespective of the scope of the taxpayer's activities in the processing as compared to the production of the commodities involved.[60]

For partnerships and S corporations, the limit is applied at the partner or shareholder level. Thus, each partner or shareholder takes into account their proportionate share of income, gain, or deduction from farming businesses of a partnership or S corporation and any applicable subsidies received by a partnership or S corporation during the tax year (regardless of whether such items are treated as income for federal tax purposes). As applied to cooperatives, the farming activities of a cooperative are attributed to each member for purposes of the definition of a farming business. Thus, a cooperative member who raises a commodity and sells it to the cooperative for processing is considered to be the processor of the commodity. Accordingly, patronage dividends received from a cooperative that is engaged in a farming business are considered to be income from a farming business.

Observation. As of mid-August 2013, the House and Senate had passed significantly different versions of the 2013 Farm Bill. It is uncertain whether the conference committee's final version of the legislation will contain direct and counter-cyclical payments or CCC loans. Thus, it is possible that the loss provision may not be applicable in the future.[61]

57. IRC §461(j).
58. IRC §461(j)(2).
59. IRC §461(j)(4)(D).
60. IRC §263A(e)(4). The provision does not apply to farming businesses that are organized as C corporations (IRC §263A(d)(3)(B)).
61. *2013 Farm Bill Update — July 2013.* Zulauf, Carl, and Schnitkey, Gary. Jul. 17, 2013.Department of Agricultural and Consumer Economics, University of Illinois. [http://farmdocdaily.illinois.edu/2013/07/2013-farm-bill-update-july.html] Accessed on Jul. 20, 2013.

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INCOME DEFERRAL OPPORTUNITIES FOR FARMERS

DEFERRAL OF LIVESTOCK SALES

There are two types of circumstances in which the Code allows farmers to defer income derived from livestock sales. When weather-related conditions or involuntary conversions occur, the farmer has tax planning options that are not normally available. The rules for each type of situation are discussed in this section.

One-Year Deferral[62]

To the extent that excess livestock is sold because of drought, flood, or other weather-related conditions, the taxpayer may defer reporting the income until the following tax year. Only **livestock in excess** of the number that would have been sold under usual business practices is eligible for the deferral. To be eligible for the 1-year deferral, the following conditions must be satisfied.

1. The taxpayer's **principal** business is **farming.**
2. The taxpayer uses the **cash method of accounting.**
3. Under **normal business practices, the sale would not have occurred** in the current year if it had not been for the drought, flood, or other weather conditions.
4. The drought, flood, or other weather condition resulted in the area being designated as **eligible for assistance by the federal government.**

The 1-year deferral election is available starting in the year in which the weather condition caused the first excess sales and ending four years following the **close of the first tax year in which any gain is recognized.**[63]

For this election, **farming**[64] includes the raising or harvesting of any agricultural or horticultural commodity, including the raising, shearing, feeding, caring for, training, and management of livestock, bees, poultry, and fur-bearing animals and wildlife by an owner, tenant, or farm operator. The taxpayer may request a letter ruling from the IRS if it is necessary to determine whether the taxpayer's principal business is farming.[65]

For the 1-year deferral due to weather, the livestock must be held for resale. However, a weather-related sale or exchange of livestock (other than poultry) held for draft, breeding, or dairy purposes may qualify for involuntary conversion treatment (discussed later in this chapter).[66]

Interestingly, the livestock does not have to be located in the area affected by the weather conditions nor does the sale need to occur within the designated area.[67] However, the early sale must have occurred solely because of the weather condition and its impact on water, grazing, or other resource related to keeping the livestock alive.

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62. IRC §451(e).
63. IRC §451(e)(3).
64. IRC §451(e)(2) defines farming by reference to IRC §6420(c)(3).
65. The IRS ruled favorably that an individual's principal business was farming when the individual had off-farm wages of $65,000 and gross sales of $121,000 from his cattle ranching business. Ltr. Rul. 8928050 (Apr. 18, 1989).
66. IRS Pub. 225, *Farmer's Tax Guide.*
67. Treas. Reg. §1.451-7(c).

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The **disaster-area designation** can be made by any authorized part of the federal government.[68] This includes the president, the Department of Agriculture or any of its agencies, and any other federal department or agency.

Caution. Treas. Reg. §1.451-7 provides the details of attaching a statement to the tax return when electing to defer income on the sale of livestock. The regulation incorrectly states that livestock held for draft, breeding, dairy, or sporting purposes are ineligible for the 1-year deferral provision. However, this regulation was adopted before the enactment of legislation that expanded the 1-year deferral privilege to include draft, dairy, breeding, or sporting animals. The regulation also incorrectly refers to drought conditions as the only cause of a sale that is eligible for deferral. After the regulation was written, the statute was amended in 1997 to extend deferral to sales on account of floods and other weather-related conditions.

The gain to be postponed is equal to the total income realized from the sale of all livestock divided by the total head sold, multiplied by the **excess number** of head sold because of the drought or other weather condition. The excess is determined by comparing the actual number of head sold to the number that would have been sold under usual business practices in the absence of the weather condition.

Observation. It is common practice to use the client's most recent 3-year average in determining the number of livestock that would be sold under normal business practices. However, this is not the actual rule. Treas. Reg. §1.451-7(b) states that "The determination of the number of animals which a taxpayer would have sold if it had followed its usual business practice in the absence of drought will be made in light of all facts and circumstances." The regulation requires the taxpayer to disclose the number of animals sold in each of the three preceding years, but if the prior three years' sales activity is not representative of normal business practice, an appropriate adjustment should be made.

If the taxpayer makes a deferral election in successive years, the amount deferred from one year to the next is **not** considered to have been received from the sale of livestock during the later year.[69] In addition, in determining the taxpayer's normal business practice for the later year, earlier years for which a deferral election was made should not be considered. Thus, if a taxpayer defers excess livestock sales from 2012 to 2013 under this election, those deferred sales are not taken into account again in 2013 when making a determination as to whether excess head were sold in the second year.

The election to postpone the gain for one year must include the taxpayer's name and address and the following information for **each** class of livestock for which the election is made.[70]

1. A statement that the election is made under IRC §451(e)
2. Evidence of the weather-related condition that forced the early sale or exchange of the livestock and the date, if known, on which the area was designated as eligible for assistance by the federal government because of the conditions
3. A statement explaining the relationship of the area of the weather-related condition to the early sale or exchange of the livestock
4. The number of animals sold in each of the three preceding years
5. The number of animals that would have been sold in the tax year had normal business practices been followed in the absence of the weather-related conditions
6. The total number of animals sold and the number sold because of the weather conditions during the year
7. The computation of the income to be postponed for each class of livestock

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

69. Treas. Reg. §1.451-7(f).

70. Treas. Reg. §1.451-7(g).

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Involuntary Conversions[71]

Taxpayers who are forced to sell livestock due to involuntary conversions may defer the gains into replacement property. There are two involuntary conversion provisions in the Code that allow gains from livestock sales to be deferred by reinvesting the proceeds.

1. Livestock destroyed by disease[72]
2. Livestock sold in excess of usual business practices due to drought, flood, or other weather-related conditions[73]

Qualifying livestock, for the purposes of the weather-related provisions, includes both animals held for resale and animals used for draft, dairy, or breeding purposes.[74] Poultry does not qualify. In addition, the weather-related condition **must have** resulted in the area being designated as eligible for federal assistance.

Like the provisions for the 1-year deferral related to weather conditions, the sale or exchange of the livestock must be solely on account of weather conditions that affect the water, grazing, or other needs of the livestock. However, it is not necessary that the livestock be held in the affected area or that the actual sale occurred in the affected area.

In general, the replacement property must be **similar or related in service or use.** This means, for example, that dairy cows should be replaced by dairy cows.[75] However, in certain circumstances, a taxpayer is allowed to replace involuntarily converted livestock sold due to weather-related conditions **or environmental contamination** with other farm property.[76] To apply this exception, it must **not be feasible** for the taxpayer to reinvest the proceeds in similar or related-use livestock because of the conditions existing as a result of the weather-related conditions or contamination. The only time real property may be used as a replacement for the livestock is when the conversion was due to soil or environmental contamination.

Example 11. Paul is a cattle rancher. Due to an extended drought in the areas where his special feed is grown, the price of feed increases to such a level that Paul can no longer afford to feed his livestock. In 2008, he was forced to sell three times as many cattle as he would have under normal business circumstances. Because the drought continues to affect the cost of feed, it is not feasible for Paul to reinvest in more cattle. In 2013, instead of buying replacement cattle, he reinvests the proceeds into 20-row soil cultivators. This farm equipment qualifies as replacement property because it **is not feasible** for Paul to reinvest in more cattle during the replacement period.

Example 12. Jane is a cattle rancher. In 2010, she was forced to sell her entire herd of cattle because her grazing land was contaminated by an oil spill. It **is not feasible** for her to replace the herd because the entire environment on her ranch is contaminated. In 2013, she reinvests the proceeds into farmland in a distant state. This farmland qualifies as replacement property because the herd was sold due to environmental factors.

Observation. The sale of breeding or dairy animals that were raised for use in a farming operation qualifies for capital gains treatment.[77] If the capital gains on the sale will be taxed at the 0% or 15% capital gain rate, it may be more beneficial to the taxpayer to recognize this gain rather than deferring it.

This is particularly true if the depreciation on the replacement animals would be claimed in a tax year when higher income tax rates apply. In addition, the depreciation reduces SE taxes. If the replacement animals qualify for IRC §179 or bonus depreciation, the taxpayer has even more options for the year in which the replacements are purchased.

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71. IRC §1033.
72. IRC §1033(d).
73. IRC §1033(e).
74. Ibid.
75. Treas. Reg. §1.1033(e)-1(d).
76. IRC §1033(f).
77. IRS Pub. 225, *Farmer's Tax Guide.*

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Replacement Period

In general, the purchase of replacement property under the involuntary conversion rules must occur within **two years** after the end of the first tax year in which any gain is realized. This is the rule that applies to gains on livestock that are sold on account of **disease.**[78]

The applicable replacement period for draft, breeding, or dairy livestock sold early on account of **weather-related conditions is four years** after the end of the first tax year in which any part of the gain on conversion is realized.[79] In addition, the IRS is given authority on a regional basis to extend the replacement period if the weather-related conditions that resulted in the application of this provision continue for more than three years.[80]

Making the Election to Defer the Gain

The election to defer the gain can be made at any time within the normal statute of limitations for the period in which the gain is realized. To make the election to defer the gain, the taxpayer should include the following information with the tax return for the year that the gain on the conversion is realized.[81]

1. Evidence of the drought, flood, or other weather-related condition that caused the early sale
2. The computation of the gain realized
3. The number and kind of livestock sold
4. The number of each kind of livestock that would have been sold under normal business practice

Reporting the Purchase of Replacement Property

For the tax year in which the proceeds from the sale are reinvested, the taxpayer should include the following information and all of the other relevant information previously included with the return for the year of the gain.[82]

1. The date of purchase of replacement livestock
2. The cost of the replacement livestock
3. The number and kind of replacement livestock

Note. The election can be made at any time within the normal statute of limitations for the period in which the gain was recognized, assuming it is before the expiration of the period within which the converted property must be replaced.[83] If the election is filed to defer gain and eligible replacement property is not acquired within the 4-year replacement period, an amended return for the year in which the gain was originally realized must be filed to report the gain.

78. IRC §1033(a)(2)(B).
79. IRC §1033(e)(2).
80. IRC §1033(e)(2)(B).
81. Treas. Reg. §1.1033(e)-1(e).
82. Treas. Reg. §1.1033(a)-2(c)(2).
83. IRC §1033(a)(2)(C)(2). See also CCA 200147053 (Sept. 28, 2001).

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DEFERRED INCOME FROM GRAIN AND LIVESTOCK SALES

Deferred Payment Contracts and Installment Reporting

Another strategy that farmers can use to defer income is to sell crops or livestock in the current tax year but defer receipt of payment until the following year. This can be accomplished by using a deferred payment contract. Because payment is received in a year after the year of sale, a deferred payment contract is taxed under the installment sales rules.[84]

The following criteria should be met for a deferred payment contract to be considered an installment sale.

1. The seller should obtain a written contract that under local law binds both the buyer and the seller. A note should not be used.
2. The contract should state clearly that under no circumstances will the seller be entitled to the sales proceeds until a specific date. A calendar-year taxpayer usually uses a date in early January of the following year.
3. The contract should be signed before the seller has the right to receive any proceeds. For farmers, the contract is often made at the time of delivery.
4. Prior to the date that the proceeds are payable to the farmer, the buyer should not credit the farmer's account for any purchases the farmer makes from the buyer. For example, a farmer may sell grain to a commodities dealer and buy seed from the same dealer. Ideally, such transactions are treated separately when billed and paid.
5. The contract should state that the taxpayer has no right to assign or transfer the contract for cash or other property.
6. The contract should include a clause that prohibits the seller from using the contract as collateral for any loans or receiving any loans from the buyer before the payment date.
7. The farmer should avoid sales through an agent in which the agent merely retains the proceeds. Receipt by an agent usually construes receipt by the seller.
8. If a third-party guarantee or standby letter of credit is issued to secure the contract, the guarantee or letter of credit should be non-negotiable, non-transferable, and only eligible to be drawn on in the event of default.
9. Price-later contracts should state that in no event may payment be received prior to the designated date, even if a price is established earlier.[85]
10. The contract may provide for interest. Interest on an installment sale is reported as ordinary income in the same manner as other interest income. If the contract does not provide for adequate stated interest, part of the stated principal may be recharacterized as imputed interest. Unstated interest is computed by using the applicable federal rate (AFR) for the month in which the contract is made.

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84. Although IRC §453(b)(2) bars installment reporting for **dealers** that dispose of personal property, IRC §453(l)(2)(A) excludes the disposition of "any property used or produced in the trade or business of farming" from being treated as a dealer disposition.

85. Crop-share landlords can use installment reporting to report the sale and income of their crop share rentals under a price-later contract in the year following the year of crop production. *Applegate v. Comm'r*, 980 F.2d 1125 (7th Cir. 1992).

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Electing Out of Installment Reporting[86]

Farm clients may have multiple deferred sale commodity contracts at yearend that effectively utilize the installment sale method to defer payment to the subsequent tax year. For those clients with sufficiently low income for the current tax year, it is possible to specifically elect out of the installment sale method for one or more deferred commodity sale contracts. This causes the income from the commodities sold under those contracts to be taxed in the year of sale rather than the year in which the proceeds of sale are collected. This election is made on a contract-by-contract basis.

> **Observation.** For maximum flexibility, the farmer could enter into multiple smaller contracts, selecting specific contracts for inclusion in income to achieve the target income. Tax returns for 2012 benefitted from this provision when larger depreciation deductions were retroactively granted on January 1, 2013, for all of 2012.

The election out is made simply by reporting the taxable sale in the year of the disposition.

> **Observation.** Care must be taken by either the farmer or the income tax return preparer to ensure that the amount of gain recognized in the year of disposition is not also recognized in the year of receipt. It may be advisable to record a receivable for the amount of accelerated sales and then reverse the entry after yearend.

> **Caution.** Deferred payment contracts are unsecured obligations and have a risk of not being paid. However, it may be possible to gain a measure of security by utilizing an escrow agreement. Grain inventory qualifies for stepped-up basis rules but deferred payment contracts do not.

An election out of installment reporting may also be beneficial if tax rates are anticipated to rise in the future. Generally, if the taxpayer elects out of the installment method, the amount realized at the time of sale is the proceeds received on the sale date and the fair market value of the installment obligation (future payments). If the installment obligation is a fixed amount, the full principal amount of the future obligation is realized at the time of the acquisition.

In order to elect out of the installment method, the taxpayer must make the election on a timely-filed return (including extensions). The election is made by recognizing the entire gain on the taxpayer's applicable form (i.e., Schedule F, Schedule D, or Form 4797) and not reporting the installment sale on Form 6252, *Installment Sale Income.*

The Treasury Regulations specify that the timely filing of an original return for the tax year in which the full amount of income from the sale is reported constitutes an election out of installment reporting.[87] The election out is generally irrevocable. A revocation of an election out of the installment method is retroactive and is not permitted when one of its purposes is the avoidance of federal income taxes.[88] However, the IRS has granted a request to amend a tax return in order to elect out of the installment method.[89] The request was granted because the taxpayers convinced the IRS that the installment sale election had been incorrectly filed on the original return based on erroneous information.

86. Treas. Reg. §15A.453-1(d).

87. Treas. Reg. §15A.453-1(d)(3).

88. Treas. Reg. §15A.453-1(d)(4).

89. Ltr. Rul. 200627012 (Apr. 4, 2006).

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WIND ENERGY TAX ISSUES

PRODUCTION TAX CREDIT

Both the federal government and numerous states provide incentives to encourage wind energy development. The federal renewable energy production tax credit (PTC) provides an income tax credit per kilowatt hour for the production of electricity from a qualified wind energy facility, the construction of which begins before January 1, 2014.[90] A **wind energy facility** consists of each separate wind turbine, together with the tower on which the turbine is mounted and the supporting pad on which the tower is situated.[91]

The credit (as adjusted for inflation) is presently 2.3 cents per kilowatt hour (KWH).[92] The credit applies to each KWH of electricity produced from wind that is sold to unrelated parties during the first 10 years after a wind energy facility is placed in service.[93] It is part of the general business credit and is subject to the same limitations based on tax liability that apply to the general business credit.

Partnership Allocation of the PTC

Generally, a partner's distributive share of income, gain, loss, deductions, and credits is determined by the partnership agreement.[94] However, a partner's distributive share of these tax attributes is determined in accordance with the **partner's interest** in the partnership if:[95]

1. The partnership agreement does not provide a method for determining the partners' distributive shares, **or**
2. The allocation to a partner under the agreement lacks substantial economic effect.

The partner's interest for these purposes is determined by taking into account all of the related facts and circumstances.

The IRS has issued guidance to wind project companies, developers, and investors for purposes of allocating PTCs derived from wind facilities.[96] The guidance provides a safe harbor method for making the allocation.

The safe harbor method allocates the PTCs in the same proportion that the partners share any income arising from the sales of the KWHs. Under the safe harbor method, there are 10 requirements, all of which must be met, for a partnership to qualify to use the safe harbor. If these requirements are satisfied, the PTCs are allocated using the method defined in Treas. Reg. §1.704-1(b)(4)(ii).

INVESTMENT TAX CREDIT

In lieu of the PTC, taxpayers may claim a 30% investment tax credit (ITC) for purchasing or constructing **qualified energy property** for the tax year that the property is placed in service.[97] The property must be part of a qualified facility that is to be used in the taxpayer's trade or business and construction must begin prior to January 1, 2014.

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90. IRC §45.
91. Rev. Rul. 94-31, 1994-1 CB 16.
92. IRS Notice 2013-33, 2013-22 IRB 1140.
93. IRC §45(b)(4)(B)(ii).
94. IRC §704(a).
95. IRC §704(b).
96. Rev. Proc. 2007-65, 2007-45 IRB 1.
97. IRC §48.

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Energy property does **not** include transmitters of electricity derived from wind energy.[98] However, a storage device can qualify for the credit. In a letter ruling, the IRS ruled that a wind farm's electricity storage device qualified. As a result, the full cost of the storage device was eligible for the ITC. The wind generation facility was located in a state with sufficient wind supply but inadequate transmission. Consequently, the storage device allowed the taxpayer to store electricity and shift deliveries from off-peak hours to peak hours.[99]

METHODS TO DETERMINE WHEN CONSTRUCTION BEGINS

The IRS has provided two methods for determining when construction began on a facility eligible for the renewable energy PTC or the ITC.[100] Only one of the methods must be satisfied to establish that construction of a facility has begun.

Under the **first method,** construction of a qualified facility begins when physical work of a significant nature begins. Work that is taken into account in determining whether construction has begun includes the following.

1. The taxpayer's work
2. Work by contractors performed under a binding written contract that was entered into before construction begins

Under the second method, the **safe harbor rule,** construction is deemed to have begun if the taxpayer incurs 5% or more of the total cost[101] of the facility before January 1, 2014, and the taxpayer makes continuous efforts to advance towards completion of the facility.

TAX REPORTING ISSUES FOR LANDOWNERS

An agreement between a landowner and a wind energy company commonly specifies three types of payments.

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

Easement Payments

The grant of a limited easement is treated as the sale of a portion of the rights in the land affected by the easement, with the proceeds first applied to reduce the basis in the land affected.[102] Because the easement is granted for only a specific portion of the property, only the basis of the land that is allocable to that portion is reduced by the amount received for the grant of the easement, with any excess over basis treated as taxable capital gain.[103] The Treasury Regulations follow this principle.[104]

There are two tax issues that must be addressed when allocating the landowner's income tax basis in the property to the rights sold and acreage affected.

1. The allocation of basis between the **rights** created by the easement and the balance of the rights in the property
2. The allocation of basis between the **acreage** of the property that is subject to the easement and the balance of the property that is not subject to the easement

98. Treas. Reg. §1.48-9(e)(1).

99. Ltr. Rul. 201208035 (Oct. 27, 2011).

100. IRS Notice 2013-29, 2013-20 IRB 1085.

101. As defined by Treas. Reg. §§1.461-1(a)(1) and (2).

102. Generally, if the grant of an easement deprives the taxpayer of practically all of the rights and beneficial interest in the land, except for the retention of mere legal title, the transaction is considered to be a sale of the land that the easement covers. In such cases, gain or loss is computed in the same manner as the sale of the land itself under IRC §§1221 or 1231. See Rev. Rul. 54-575, 1954-2 CB 145; and Rev. Rul. 59-121, 1959-1 CB 212.

103. See, e.g., *Conway v. U.S.,* 73-1 USTC ¶9.318 (W.D. Ky. 1973); Rev. Rul. 68-291, 1968-1 CB 351; Rev. Rul. 59-121, 1959-1 CB 212.

104. Treas. Reg. §1.61-6(a).

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Allocation Based on Rights. Income tax basis must be allocated between the rights that the taxpayer retains and the easement rights that are sold. For purposes of this basis allocation, the general rule is that the allocation of basis in the property must be allocated between the interest sold and the interest retained in the proportions that their respective fair market values bear to the fair market value of the entire property.[105] If it is not possible to allocate basis of the entire property between the interest that is sold and the interest that is retained, then the amount received for the easement can be used to reduce the basis in the entire property affected.[106]

Allocation Based on Acreage. In most cases, the easement is granted for a quantifiable number of acres owned by the taxpayer. The basis in the property must be allocated proportionately to the acreage affected.

Example 13. In 2013, Garrulous Energy Company pays $4,000 for an easement along the eastern boundary of Marcia Megawatt's farm for the construction of an access road to the location on Marcia's farm where a wind turbine will be erected. The easement covers approximately five acres of Marcia's 160-acre farm. Marcia's tax basis in her farmland is $750 per acre. Marcia's taxable gain from the easement payment is $250, as calculated below.[107] The remaining basis in the five acres is now zero.

Easement price	$4,000
Less: $750 basis × 5 acres affected by easement	(3,750)
Taxable gain	$ 250

6

Allocation of Easement Payments to Reduce Basis in the Entire Property. If the easement **truly affects the taxpayer's entire property** (which is uncommon), the amount received for the easement first reduces the taxpayer's basis in the entire property. Once the payments exceed the entire basis, the taxpayer realizes a taxable gain.[108]

Example 14. Larry Landowner sells multiple easements to Tumescent Wind Corporation for access to a major wind turbine project on Larry's farm. The easements cover 50 acres and bisect Larry's property. Tumescent constructed fences on each side of every easement and installed gates in the fences so that Larry could move his livestock through the easements.

If Larry can establish that the easements affect his use of all his property rather than just the 50 acres covered by the easements, Larry can first reduce the basis in all of his ranchland by the amount he receives for the easements before reporting any gain.

It may be possible to determine the actual portion of a client's property that is affected by a wind farm project by examining the terms of the particular easement. **Many easement agreements prohibit the landowner from building anything else on the property that would interfere with the maintenance of the windmill or block the wind that drives the windmill.** That could give the landowner an argument that the easement affects **all** of the landowner's property. If there is sufficient basis in the land to absorb the easement payment, the landowner has no gain to report.

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

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

107. For further guidance on the calculation technique utilized in the example, see Rev. Rul. 68-291, 1968-1 CB 351.

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

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Example 15. Tom owns an 80-acre tract of farmland with no improvements. It is entirely pastureland, and Tom paid $40,000 for the tract in 1983. Tom has been approached by a wind energy company to construct three wind turbines on his property. The company is willing to pay Tom $25,000 for an easement. The easement terms prevent Tom from building anything on this property that would obstruct the company's access to the wind turbines or that would block the wind to the turbines. Tom should be able to reduce the basis in his entire tract by the amount of the easement payment. That would result in his basis being reduced to $15,000, and Tom would not have any gain to report.

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

Caution. Practitioners should consider whether, realistically, the taxpayer is likely to plant any trees or construct any buildings that could interfere with wind turbines that are 400 feet tall. Although the standard no-interference clause restricts the use of the property, a determination should be made as to the way the taxpayer ordinarily uses the remaining acres.

There is case law **supporting the argument** that an easement can affect **all** of a taxpayer's property, therefore allowing the taxpayer to offset the entire basis in the property prior to reporting any gain.

1. ***Bledsoe v. U.S.*** The landowner sold nine perpetual easements to the U.S. Army Corps of Engineers to allow road access to a dam. Although the easements covered only 47.3 acres, the court allowed the landowner to reduce the basis of the entire property because the easements restricted his use of the property. The easements varied in width from 100 to 400 feet and bisected his ranch. The easement holder then constructed a fence along the road on both sides and built gates in the fences so that the taxpayer could move his cattle across the easements. The court noted that the easements were not sales and that the taxpayer was entitled to apply the easement proceeds against the basis in the property.[109]

Note. Easements are **usually** treated as sales.

2. ***Inaja Land Co., Ltd. v. Comm'r.*** The city of Los Angeles paid the landowner $50,000 for an easement that allowed the city to flood the land when it diverted water into a river that flowed through the land. The easement did not cover the entire tract, but because it affected the use of the entire tract, the court allowed the payment for the easement to reduce the basis of the entire tract.[110]

3. ***Foster, et al. v. Comm'r.*** The amount received for an easement was applied against the taxpayer's basis in the entire property. Previous payments from a utility company for a right-of-way were treated as severance damages. An additional amount paid for a sway easement in order to protect the original right-of-way easement was also determined to have reduced the basis in the entire property. The court found that both easements were integrally related and affected the entire property.[111]

Caution. No substantial authority currently exists to support the reduction-in-basis interpretation in the context of wind energy easement contracts, even those containing the standard no-interference clause.

The court cases cited previously do not deal specifically with the no-interference standard covenant clause found in many wind energy easement contracts. Therefore, until the courts actually rule on this issue, this tax treatment is aggressive.

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

[110]. *Inaja Land Co., Ltd. v. Comm'r*, 9 TC 727 (1947).

[111]. *Foster, et al. v. Comm'r,* 80 TC 3 (1983).

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Recommendations.

1. Until there is a court decision specific to wind energy easements in which the court finds that it is impracticable or impossible to determine the specific portion of the property affected by the easement, practitioners are advised to **proceed with caution.**[112]
2. If the reduction-in-basis interpretation is used, a practitioner should consider disclosing the facts of the situation and the supporting arguments for this treatment. The disclosure should be made on Form 8275, *Disclosure Statement*, if the reasonable basis or substantial authority standards are met.
3. If the gain from the sale of the easement rights is significant, practitioners should consider requesting a letter ruling from the IRS for their client's specific situation.

Note. See pages 383–384 and 536–538 in the 2008 *University of Illinois Federal Tax Workbook* for more details on this issue. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

Crop Damage Payments

Payments that are made for crop damage are reported as payments received for the sale of the crop. Thus, a farmer reports the payment as crop sales on Schedule F, *Profit and Loss from Farming;* a crop-share landlord reports it as income from crops on Form 4835, *Farm Rental Income and Expenses*.

Lease Payments

In addition to the payment for the easement, landowners commonly receive annual lease payments. The amount of the lease payment is often associated with the amount of production from the turbines.

Because these payments are not for land used in agricultural production, they are not subject to SE tax regardless of the landowner's participation in the activity.[113] Accordingly, the annual lease payment income is reported on Schedule E, *Supplemental Income and Loss.* The landowner generally has few or no deductible rental expenses.

STATE TAX INCENTIVES

Numerous states provide tax incentives for electricity that is generated by wind power. These incentives include property tax breaks,[114] sales tax exemptions on wind energy equipment purchases, and corporate and financing incentives. The following are tax incentives available in some states.

- Wind energy may qualify as an alternative and renewable energy source for purposes of a **state-level renewable energy tax credit.** Typical eligibility is for a "wind energy conversion facility," which usually requires that a majority of the ownership interests be held by certain qualified persons or entities. Often, a state utilities board or comparable organization must approve the facility.
- Wind energy property may receive favorable **property tax** treatment. Qualified property typically includes windmills, wind turbines, towers, and electrical equipment and substations. For example, Texas allows a deduction from state franchise tax for renewable energy sources **and** several property tax incentives. Texas also provides for the allowance of local property tax abatements for wind projects in the state. These abatements exempt all or part of the increase in real or tangible personal property for up to 10 years. In Texas, local governments are the sole grantors of these abatements, which are used to create local reinvestment zones to foster job creation and economic development.

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112. *See, e.g., Fasken v. Comm'r,* 71 TC 650 (1979) (Taxpayer granted four easements for utility lines and the court required the consideration received for the easements to be applied against the portion of the adjusted basis for the ranch allocable to the acreage affected by each particular easement instead of applying the consideration against the ranch's entire basis. Taxpayer unable to show that the usefulness of the ranch was impacted by the easements or that it was not possible to allocate basis to the area actually impacted by each easement.)

113. IRC §1402(a)(1).

114. See, e.g., Kan. Stat. Ann. §79-201.

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- Wind energy property may also receive favorable **state sales tax** treatment (including exemption from tax). The typical property that is covered includes wind chargers, windmills, wind turbines, tower and electrical equipment, pad-mounted transformers, power lines and substations, and cranes used to install qualified property. However, equipment used to construct roads for use in the construction of qualified property usually does not receive favorable tax treatment.
- States sometimes impose a **replacement generation tax** of a certain amount per kilowatt hour of electricity produced in the state in place of a property tax on energy generation facilities. However, wind energy facilities are typically exempted from the tax. For example, Minnesota exempts all wind energy systems from state property tax. Instead, Minnesota taxes the actual wind energy produced at variable rates, depending on the megawatts per system.
- Some states have enacted legislation allowing banks to qualify for tax credits for investment in wind energy facilities.
- A state-level incentive for smaller-sized wind energy production may also be available.

DOMESTIC PRODUCTION ACTIVITIES DEDUCTION

IRC §199 allows taxpayers to claim a deduction on their income tax returns based on their net income from most production activities in the United States. The domestic production activities deduction (DPAD) for tax years beginning after 2009 is limited to the lowest of:

1. 9% of the qualified production activities income (QPAI),
2. 9% of the entity's taxable income without regard to §199 (modified adjusted gross income for individual taxpayers), and
3. 50% of Form W-2 wages paid during the year by the taxpayer that are allocable to domestic production gross receipts (DPGR).

Note. Except for the oil and gas industry, the 6% rate increased to 9% for tax years beginning after 2009. (The deduction rate was 3% in 2005 and 2006.)

QPAI equals DPGR reduced by the **sum** of the following.

1. Cost of goods sold allocable to DPGR
2. Other deductions and expenses directly allocable to DPGR
3. A share of other deductions and expenses that are not directly allocable to DPGR or another class of income

Observation. For many farmers, QPAI is the sum of the net income reported on Schedule F, *Profit or Loss from Farming,* and net gain from the sale of raised livestock reported on Form 4797, *Sales of Business Property*. However, there are exceptions to this general rule.

DPGR is defined as receipts derived from the lease, rental, license, sale, exchange, or other disposition of qualifying production property that is manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States.[115] Qualifying activities include cultivating soil, raising livestock, and fishing as well as storage, handling, and other processing (other than transportation activities) of agricultural products.[116]

115. IRC §199(c)(4).

116. Treas. Reg. §1.199-3(e)(1).

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For many farmers, the major limiting factor for the DPAD is that it cannot exceed 50% of Form W-2 wages. Many farmers have little or no paid labor. In addition, wages for which withholding is not required are excluded from Form W-2 wages. For example, the following forms of compensation are not included in Form W-2 wages.

- Wages paid in commodities
- Wages paid for agricultural labor to a child of the proprietor who is under age 18 or to a child under age 18 who is the child of each of the partners in a partnership
- Compensation paid in the form of nontaxable fringe benefits

Note. For tax years beginning after May 17, 2006, only the wages allocable to DPGR are qualified wages for purposes of the 50%-of-wages limitation.

APPLICATION TO COOPERATIVES

The DPAD can be confusing for members of cooperatives. Unlike the treatment of owners of other pass-through entities, such as partnerships and S corporations, the DPAD deduction for products sold by a cooperative is calculated at the entity level. The cooperative can elect to pass part or all of the DPAD through to its members based on their patronage.[117] Consequently, the deduction on the member's tax return is **not limited** by the member's AGI or Form W-2 wages.

A cooperative engaged in marketing agricultural and horticultural products is treated as having produced any products that are produced by its patrons and marketed by the cooperative.[118] In determining the pass-through DPAD, the cooperative's taxable income and QPAI are computed without taking into account any deductions for patronage dividends, per-unit retain allocations, and nonpatronage distributions under IRC §1382(b) and (c).[119]

This rule led many cooperatives to take a closer look at how they characterized their payments for the members' commodities. The characterization depends on the member agreement with the cooperative. The IRS was asked to examine several agreements and began issuing letter rulings on the matter in 2008. The IRS has taken the position that payments a cooperative makes to its members for their commodities are advance per-unit retains payment in money (PURPIM). Consequently, a cooperative does not have to deduct those payments from its DPGR to compute its QPAI. The result is that a cooperative's ability to treat the payments for commodities as PURPIM significantly increases the cooperative's QPAI and the DPAD the cooperative can elect to pass through to its members.

2013 Developments

The DPAD is a deduction only against patronage-sourced income; it cannot be computed by aggregating patronage- and nonpatronage-sourced income. Because cooperatives compute gross patronage-sourced income for DPAD purposes without deducting PURPIM, patronage-sourced income is higher than it otherwise would be. This gives cooperatives an advantage over corporations.

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117. IRC §199(d)(3).

118. IRC §199(d)(3)(D); Treas. Reg. §1.199-6(d). Any farmers' cooperative exempt from tax under IRC §521 qualifies if it is engaged in the manufacture, production, growing, or extraction of any agricultural or horticultural product or in the marketing of any agricultural or horticultural product. IRC §199(d)(3)(F). Taxable corporations operating on the cooperative basis are also eligible for the DPAD on patronage-sourced income.

119. IRC §199(d)(3)(C)sm; Treas. Reg. §1.199-6(c). See also Ltr. Rul. 201250009 (Sep. 11, 2012).

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In CCM 20131802F,[120] a Subchapter T cooperative computed its DPAD by aggregating income from both patronage and nonpatronage sources. The nonpatronage sources had negative QPAI, which would have resulted in a DPAD of zero if it were calculated separately from the income derived from patronage sources. Thus, by calculating patronage- and nonpatronage-sourced income together, the cooperative was able to use half of its nonpatronage wages in computing its DPAD. The IRS, citing *Farm Service Cooperative v. Comm'r,*[121] noted that a cooperative cannot deduct Form W-2 wages from nonpatronage activities against income from patronage activities. Thus, the cooperative had to perform separate DPAD calculations for patronage and nonpatronage activities.

Similarly, in CCM 20132701F,[122] a large integrated and diversified agricultural concern that was also a Subchapter T cooperative operated both a grain marketing and agricultural supply cooperative. It marketed grain on a patronage basis for its members, which included both farmers and local grain cooperatives. It treated all payments made to members and nonmembers for grain as purchases and not as PURPIM. Thus, the grain purchases became part of the cooperative's cost of goods sold.

In late 2009, the IRS issued a letter ruling to the cooperative that said that the grain payments to members and eligible nonmember patrons were PURPIM and that the cooperative's DPAD was to be computed without taking a deduction for grain payments to the members and eligible nonmember patrons. The cooperative then sought IRS guidance concerning whether its increased DPAD caused by the reclassification of purchases to PURPIM (which had the effect of reducing the cooperative's nonpatronage income for the year) could offset the cooperative's nonpatronage-sourced income. The IRS determined that, because the enhanced DPAD was entirely attributable to the cooperative's patronage grain business, it could only be used to offset patronage-sourced income. The DPAD resulting from the reclassification was inherently patronage-based. As such, the enhanced DPAD amount could only be used to reduce patronage-sourced income, not nonpatronage-sourced income.

In a DPAD case not involving a cooperative, *U.S. v. Dean, et al.,*[123] the defendant, a shareholder of an S corporation that utilized a production process for assembling gift baskets containing food and wine items for sale, claimed a flow-through DPAD. The defendant claimed that designing gift baskets involved a complicated, multi-step process including the selection of sizes, colors, and materials, ensuring quality control, and reviewing packaging. The actual production of the baskets was outsourced, and food items in the baskets were either purchased as individually wrapped packages or repackaged by a contract-hire co-packer. The workers functioned in an assembly-line style to produce the baskets into "gift towers."

The S corporation did not claim a DPAD on its original 2005 return but did claim a $275,982 DPAD on an amended return filed in 2009. The defendant claimed 75% of the S corporation's DPAD on his personal return. The IRS issued a refund, but later sued to recover the amount refunded. The IRS claimed that the S corporation only packaged and repackaged items in baskets and gift towers and was not entitled to a DPAD because the activity did not involve any "manufacturing" or "production" of qualified property. The defendant claimed that the S corporation was engaged in the manufacturing and production of gift baskets and towers. The court determined that the activity involved qualified manufacturing or production in accordance with Treas. Reg. §1.199-3(e)(2). The court found it significant that the S corporation's business created a new product with a different demand.

120. CCM 20131802F (Feb. 27, 2013).

121. *Farm Service Cooperative v. Comm'r*, 619 F.2d 718 (8th Cir. 1980).

122. CCM 20132701F (May 16, 2013).

123. *U.S. v. Dean, et al.*, 2013 U.S. Dist. LEXIS 65357 (C.D. Cal. May 7, 2013).

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SELF-EMPLOYMENT TAXATION OF CONSERVATION RESERVE PROGRAM PAYMENTS

CURRENT DEVELOPMENTS

Since the late 1980s, the IRS and the courts have issued various rulings, advices, notices, and opinions concerning whether conservation reserve program (CRP) payments are subject to SE tax. Until 2003, the IRS always took the position that a taxpayer had to materially participate in a farming operation for CRP payments to be included in net income subject to SE tax. The courts agreed.

However, in 2003 the IRS took the position in a Chief Counsel Advice[124] that the mere signing of a CRP contract resulted in the signing taxpayer being engaged in the trade or business of farming. Accordingly, CRP payments should be included in net SE income. On June 18, 2013, the U.S. Tax Court issued an opinion agreeing with the relatively new position of the IRS.[125]

> **Observation.** The court's decision will affect taxpayers who are passive farmland investors or nonfarming heirs. CRP payments received by these taxpayers will be included in net income subject to SE tax. However, under the Code,[126] **taxpayers who receive social security benefits are specifically excluded from including CRP payments in net SE income.**

Primary Basis for the IRS's Position

Announcement 83-43.[127] The primary authority for the IRS's position is Announcement 83-43. This announcement concluded that farms participating in certain programs still qualify for special-use valuation for estate tax purposes[128] and the right to pay federal estate taxes in installments.[129]

In reaching that conclusion, the IRS determined that participation in the payment-in-kind (PIK) program or any other land diversion program was considered **active conduct of a farming business.** The IRS also stated that this would still be true if a taxpayer's entire farm were devoted to conservation use under the program.

The announcement further concluded that the cash rental amount received by a **farmer** for participation in the PIK program is subject to SE tax. However, it did not address whether PIK payments received by a **nonfarmer** or retired farmer are subject to SE tax.

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124. CCA 200325002 (May 29, 2003).

125. *Morehouse v. Comm'r*, 140 TC 16 (2013).

126. IRC §1402(a)(1).

127. IRS Ann. 83-43, 1983-10 IRB 28.

128. IRC §2032A.

129. IRC §6166.

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

- In Ltr. Rul. 8729037,[130] the first IRS ruling issued after the creation of the CRP in the 1985 Farm Bill, the IRS ruled that the CRP is similar to the PIK program and that a qualified heir's participation in the CRP would not trigger recapture of estate tax under IRC §2032A for failure to use the elected land as a farm for farming purposes. To elect special-use valuation in a decedent's estate, the decedent must have been using the land for farming purposes for a specified period of time before death and the qualified heir(s) must continue the farm use for 10 years after the decedent's death. The ruling provides no guidance on the question of whether a taxpayer who is either retired from farming or has never been a farmer is converted into a farmer by virtue of enrollment of land into the CRP.

- In Ltr. Rul. 8745016,[131] the IRS ruled (based on Announcement 83-43) that a qualified heir's participation in the CRP does not trigger recapture of federal estate tax under IRC §2032A for failure to use the land as a farm for farming purposes. In Ltr. Rul. 8802026,[132] the IRS again ruled that a qualified heir's participation in the CRP does not trigger recapture of federal estate tax under IRC §2032A for failure to use the land as a farm for farming purposes.

- In Ltr. Rul. 8822064,[133] the IRS ruled that CRP payments are to be considered receipts from farming operations rather than rents from real estate (which would be excluded from SE tax by virtue of IRC §1402(a)(1)). However, the IRS noted in the ruling that the taxpayer (who was 71 years old and had been personally farming the land during the year immediately before enrolling the land in the CRP) was retired from farming. As such, the IRS ruled that the CRP payments were not subject to SE tax. The IRS referenced Rev. Rul. 68-44,[134] Rev. Rul 65-149,[135] and Rev. Rul. 60-32,[136] to bolster its position. In those rulings, the IRS stated that annual payments under farm programs comparable to the CRP are in the nature of farm receipts from farm operations and are not rental payments. However, the IRS stated in the rulings that such payments are not subject to SE tax if the taxpayer was not materially participating in farming operations (either personally or via a lease) on land that is not in the government land diversion program.

- Tech. Adv. Memo. 9212001[137] involved a taxpayer engaged in the active trade or business of farming, who purchased land previously enrolled in the CRP. The taxpayer subsequently died while still engaged in the trade or business of farming on the non-CRP land. The question was whether the CRP land constituted a closely-held business interest for purposes of an IRC §6166 election (installment payment of federal estate tax) in the taxpayer's estate. The IRS ruled that the CRP land did constitute an interest in a closely-held business for purposes of IRC §6166 because it was part of the taxpayer's trade or business of farming along with the other property used by the taxpayer (before death) in the trade or business of farming.[138]

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130. Ltr. Rul. 8729037 (Apr. 21, 1987).

131. Ltr. Rul. 8745016 (Aug. 7, 1987).

132. Ltr. Rul. 8802026 (Oct. 14, 1987).

133. Ltr. Rul. 8822064 (Mar. 7, 1988).

134. Rev. Rul. 68-44, 1968-1 CB 191.

135. Rev. Rul. 65-149, 1965-1 CB 434.

136. Rev. Rul. 60-32, 1960-1 CB 23.

137. TAM 9212001 (Jun. 20, 1991).

138. The ruling is silent as to whether such CRP land would constitute an interest in the trade or business of farming if the taxpayer was not engaged in the trade or business of farming by virtue of being retired or a passive investor in farmland.

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PREVIOUS COURT RULINGS

The courts have consistently ruled that rental payments are subject to SE tax in the hands of a taxpayer **who is engaged in a trade or business and the rental payments relate to that business**. Conversely, the courts have ruled that if the taxpayer is not engaged in a trade or business, rental payments, by themselves, are insufficient to constitute a trade or business that would result in the payments being subject to SE tax.

> **Note.** IRC §1402(a)(1) provides that rents from real estate are not included in net earnings from self-employment. However, in Ltr. Rul. 8822064,[139] the IRS ruled that CRP rental payments are receipts from farming operations rather than rents from real estate. Thus, they are not excluded from SE tax by virtue of the statutory exception under IRC §1402(a)(1).

The IRS's position is that CRP payments are not considered **rental income** from land, which, by definition, is exempt from SE tax.[140] The U.S. Court of Appeals for the 6th Circuit agreed with the IRS in *Wuebker v. Comm'r.*[141] The court held that the services required under the CRP contract were substantial enough to classify the payments as **services rendered to the occupant.**[142] Thus, the CRP payments were not considered rental payments. Ultimately, because the taxpayers were active farmers, the court held that the CRP payments were subject to SE tax due to the nexus with the taxpayer's existing farming operation. The court's opinion followed the rationale of *Ray v. Comm'r,*[143] in which the court ruled that the SE tax treatment of CRP payments was dependent on a **direct nexus** to an existing farming operation the taxpayer conducted.

> **Observation.** The taxpayers in *Wuebker* were active farmers. The case lends no support to the notion that nonfarmers owe SE tax on CRP rental income.

For income to be subject to SE tax, other courts have similarly required a taxpayer to **materially participate** in a farming trade or business personally, via agent, or through a lease. That was the case in *Henderson v. Flemming*,[144] *McNamara v. Comm'r*,[145] and *Bot v. Comm'r*.[146]

Conversely, in *Dugan v. Comm'r*,[147] a taxpayer was held **not liable** for SE tax on income from share-farming operations conducted with a friend because the taxpayer did **not materially participate** in farming operations. In this case, the tenant made all of the decisions and performed all of the work in the farming activity. In its decision, the court noted that for the income to be subject to SE tax under the Code,[148] the lease agreement must require material participation from the landowner **and** the landowner must in fact materially participate. Importantly, the contract (lease agreement) between the landlord and the tenant was insufficient, by itself, to subject the lease payments to SE tax in the landlord's hands. Instead, an examination of the facts was necessary to determine whether the taxpayer was engaged in a trade or business that resulted in the payments being subject to SE tax. That approach is consistent with the U.S. Supreme Court's opinion in *Comm'r v. Groetzinger.*[149] In *Groetzinger,* the Court noted that whether a taxpayer is engaged in a trade or business requires a factual determination in every case.

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139. Ltr. Rul. 8822064 (Mar. 7, 1988).
140. IRC §1402(a)(1).
141. *Wuebker v. Comm'r,* 205 F.3d 897 (6th Cir. 2000).
142. See Treas. Reg. §1.1402(a)-4(c)(2).
143. *Ray v. Comm'r,* TC Memo 1996-436 (Sep. 25, 1996).
144. *Henderson v. Flemming,* 283 F.2d 882 (5th Cir. 1960).
145. *McNamara v. Comm'r,* 236 F.3d 410 (8th Cir. 2000).
146. *Bot v. Comm'r,* 353 F.3d 595 (8th Cir. 2003).
147. *Dugan v. Comm'r,* TC Memo 1994-578 (Nov. 28, 1994).
148. IRC §1402(a)(1).
149. *Comm'r v. Groetzinger,* 480 U.S. 23 (1987).

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The court previously found that CRP income was not in itself sufficient to establish that the taxpayers were in the trade or business of farming. *Hasbrouck v. Comm'r*[150] involved a situation in which the taxpayers had never been engaged in the trade or business of farming but purchased CRP land. The taxpayers signed a CRP contract to continue enrollment of the land in the CRP, and the USDA determined that the taxpayers were actively engaged in farming. Based on that determination, the taxpayers filed a Schedule F with a net loss after reporting the CRP income and deducting farming expenses. The IRS disallowed the loss on the basis that the taxpayers were **not** actively engaged in the trade or business of farming during the tax year at issue. The court held that the IRS's position was substantially justified.

The 2003 CCA and the 2006 Notice

In CCA 200325002,[151] the Chief Counsel's office took the position for the first time that CRP payments are subject to SE tax regardless of whether the taxpayer is actively conducting a farming operation on land that is not in the CRP. The IRS took this position without the support of any court cases.

On December 5, 2006, the IRS issued a notice[152] of a **proposed** revenue ruling concerning the SE tax treatment of CRP payments. The notice concluded that participation in the CRP, in and of itself, constitutes a trade or business. The IRS determined that the CRP requires the recipient to perform certain activities, such as tilling, fertilizing, seeding a cover crop, and controlling weeds. These activities were considered significant enough to constitute SE activity, even if the taxpayer hired someone else to perform the services. However, the IRS did not issue the revenue ruling proposed in this notice.

2013 DEVELOPMENT — ANALYSIS OF *MOREHOUSE V. COMM'R*

On June 18, 2013, the U.S. Tax Court released its opinion in *Morehouse v. Comm'r*.[153] The facts of the case are fairly straightforward. Rollin Morehouse, the petitioner, was a nonfarmer who lived in Texas and worked for the University of Texas. In 1994, he inherited farmland in South Dakota and bought other farmland from his family members. He never personally farmed the land but rented it to others who farmed it. In 1997, he put the bulk of the property in the CRP while continuing to rent out the non-CRP land. He hired a local farmer to maintain the CRP land consistent with the CRP contract, including such activities as planting a cover crop and controlling weeds. In 2003, Mr. Morehouse moved to Minnesota.

Mr. Morehouse personally fulfilled some of the obligations under the CRP contracts, such as filing certifications and purchasing materials. However, he never personally engaged in farming activities. Consequently, the petitioner reported his CRP income as rental income not subject to SE tax on Schedule E. After receiving notices of deficiency from the IRS, Mr. Morehouse took the case to court to determine whether he was liable for SE tax on the CRP payments he received.

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150. *Hasbrouck v. Comm'r,* TC Memo 1998-249 (Jul. 7, 1998).

151. CCA 200325002 (May 29, 2003).

152. IRS Notice 2006-108, 2006-51 IRB 1118.

153. *Morehouse v. Comm'r,* 140 TC No. 16 (2013).

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Tax Court's Holding and Reasoning

The Tax Court ruled in favor of the IRS that the CRP payments must be included in the calculation of net earnings subject to SE tax. **The court determined that the petitioner was in the business of participating in the CRP with the intent to make a profit.**

The IRS argued that Mr. Morehouse received the CRP payments "from his trade or business of conducting an environmentally friendly farming operation." The court found that Mr. Morehouse met the following 2-prong test established by *Comm'r v. Groetzinger*[154] for determining whether an activity is considered a trade or business.

1. The taxpayer must be involved in the activity with continuity and regularity.
2. The taxpayer's primary purpose for engaging in the activity must be for income or profit.

The court found that Mr. Morehouse met the first test both through his own actions and through those of his agent, the farmer. The court did not rule on the second test because Mr. Morehouse's profit motive was not in question.

Observation. A taxpayer who owns farmland in an S corporation may be subject to additional IRS scrutiny as a result of the *Morehouse* opinion. Normally, all of the farm rental income, including the CRP rental income, received by an S corporation is not subject to SE tax. However, because the *Morehouse* decision concludes that a taxpayer participating in the CRP is engaged in a trade or business, the IRS could argue that the S corporation must reasonably compensate the taxpayer for the value of the services provided to the S corporation related to the CRP contract.

However, if the S corporation reasonably compensates the taxpayer and the compensation is less than the net income from the CRP land, the taxpayer may save some taxes compared to owning the land outside of the corporation.

This, of course, presumes that the S corporation had not previously been a C corporation with retained earnings. If the corporation was previously taxed as a C corporation, an S corporation with passive rental income that exceeds 25% of gross receipts could become subject to a 35% tax on passive income. If the limit is exceeded for three consecutive years, the S election is automatically terminated.

Problems with the *Morehouse* Court's Analysis[155]

The court skipped entirely over the material participation requirement and determined the existence of a trade or business on either the petitioner's personal involvement with the CRP contract[156] or through the local farmer that he hired to maintain the land. The court cited the 6th Circuit's decision in *Wuebker*[157] as controlling even though the taxpayer in that case was an active farmer and the petitioner in *Morehouse* was a mere investor who had never been engaged in farming. Thus, *Wuebker* was factually distinguishable. However, the court stated that Mr. Morehouse was in the business of maintaining "an environmentally friendly farming operation."

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154. *Comm'r v. Groetzinger*, 480 U.S. 23 (1987).

155. *U.S. Tax Court Says Non-Farmer's CRP Income Is Subject to Self-Employment Tax.* McEowen, Roger. Jun. 20, 2013. Iowa State University Center for Agricultural Law and Taxation. [www.calt.iastate.edu/briefs/CALT%20Legal%20Brief%20-%20CRP%20Payments.pdf] Accessed on Jul. 22, 2013.

156. The court noted that the CRP contract required seeding of a cover crop and maintenance of weed control, that the petitioner visited the properties on occasion to ensure that the CRP contract requirements were being satisfied, participated in emergency haying programs and requested cost-sharing payments, and made the decision as to whether to re-enroll the properties in the CRP upon contract expiration.

157. *Wuebker v. Comm'r,* 205 F.3d 897 (6th Cir. 2000).

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The Tax Court's opinion in *Morehouse* is contrary to the court's prior opinions on the trade or business issue. Although, as the **Tax Court ruled in *Morehouse*, CRP payments may not constitute "rents from real estate"** such that they are exempt from SE tax under the exception set forth in IRC §1402(a)(1), that determination has no bearing on the issue of whether the taxpayer is engaged in a trade or business as required by §1402(a). That question can only be answered by examining the facts pertinent to a particular taxpayer. Mere signing of a CRP contract and satisfying the contract terms via an agent is insufficient to answer that question. The Tax Court had already answered that question in *Dugan*.[158] That case (which also involved a South Dakota operation) **stands for the proposition that the contract (lease agreement) between the landlord and the tenant is insufficient, by itself, to subject the lease payments to SE tax in the landlord's hands.**[159]

The court also made no mention of its prior opinion in *Vianello v. Comm'r*,[160] which would appear to be directly on point on the trade or business issue. In *Vianello*, the taxpayer was a CPA who, during the years in issue, operated an accounting firm in the Kansas City area. In 2001, the petitioner acquired 200 acres of cropland and pasture in southwest Missouri approximately 150 miles from his office. At the time of the acquisition, a tenant (pursuant to an oral lease with the prior owner) had planted the cropland to soybeans. Under the lease, the tenant was to deduct the cost of chemicals and fertilizer from total sale proceeds of the beans and pay the landlord one-third of the sale amount. The petitioner never personally met the tenant during the years at issue, but the parties did agree via telephone to continue the existing lease arrangement for 2002. Accordingly, the tenant paid the expenses associated with the 2001 and 2002 soybean crops and provided the necessary equipment and labor. The tenant made all the decisions with respect to raising and marketing the crop and paid the petitioner one-third of the net proceeds. The tenant also mowed the pasture and maintained the fences.

Ultimately, a disagreement between the petitioner and the tenant resulted in the lease being terminated in early 2003, and the petitioner had another party plow under the fall-planted wheat in the spring of 2004 prior to the planting of Bermuda grass. Also, the petitioner bought two tractors in 2002 and a third tractor and hay equipment in 2003 and bought another 50 acres in late 2003.

The petitioner did not report any Schedule F income for 2002 or 2003 but did claim a Schedule F loss for each year as a result of depreciation claimed on farm assets and other farming expenses. The petitioner concluded, based on a reading of IRS Pub. 225, *Farmer's Tax Guide,* that he materially participated in the trade or business of farming for the years at issue. The petitioner claimed involvement in major management decisions, provided and maintained fences, and discussed row crop alternatives, weed maintenance, and Bermuda grass planting with the tenant. The petitioner also claimed he bore the risk of loss under the lease because an unsuccessful harvest would mean that he would have to repay the tenant for the tenant's share of chemical costs.

The Tax Court determined that the petitioner was not engaged in the trade or business of farming for 2002 or 2003. The court noted that the tenant paid all the expenses with respect to the 2002 soybean crop and made all of the cropping decisions. In addition, the court noted that the facts were unclear as to whether the petitioner was responsible under the lease for reimbursing the tenant for input costs in the event of an unprofitable harvest.

Importantly, the court noted that the USDA's determination that the petitioner's revocable trust satisfied the active engagement test and was a co-producer with the tenant for farm program eligibility purposes "has no bearing on whether petitioner was engaged in such a trade or business for purposes of section 162(a) . . .".

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158. *Dugan v. Comm'r,* TC Memo 1994-578 (Nov. 28, 1994).

159. The Tax Court did not refer to its prior opinion in *Dugan*.

160. *Vianello v. Comm'r*, TC Memo 2010-17 (Feb. 1, 2010).

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The Tax Court declined to utilize an "arrangement" analysis consistent with the approach utilized in *Mizell v. Comm'r*[161] in determining whether the petitioner was engaged in the trade or business of farming. However, the court did specifically note that the regulations under IRC §1402 **"make it clear that petitioner's efforts do not constitute production or the management of the production as required to meet the material participation standard."** That is a key point. The petitioner was **not** engaged in the trade or business of farming either for deduction purposes or SE tax purposes.

Note. In *Vianello,* the Tax Court noted that the taxpayer must satisfy the material participation test in order for rental income to be subject to SE tax. That point was not addressed in *Morehouse.*

The Tax Court's *Morehouse* decision is the first court opinion holding that a nonfarmer's CRP income is subject to SE tax simply by virtue of signing a CRP contract. As a result of the *Morehouse* decision, it is hard to imagine any situation in which CRP rental income will **not** be subject to SE tax — especially in the 8th Circuit (Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota). The case is appealable to the 8th Circuit.

FARM BANKRUPTCY TAXATION

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

Note. For a full discussion of the BAPCPA amendments to Chapter 12 bankruptcy, see the 2008 *University of Illinois Federal Tax Workbook,* Chapter 14: Agricultural Issues and Rural Investments. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

Before amendment by 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 with it tax consequences to the debtor that could negatively impact the feasibility of the debtor's reorganization plan. However, under BAPCPA, a Chapter 12 debtor can treat claims arising out of "claims owed to a governmental unit" as a result of "sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation" as an unsecured claim that is **not entitled to priority** under section 507(a) of the Bankruptcy Code, provided the debtor receives a discharge. The provision became effective upon enactment, April 20, 2005. The amended statutory language specifies that a Chapter 12 plan must:

> *(1) 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; …*[162]

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 post-petition sale of farm assets, and what qualifies as a "farm asset." For a full discussion of the issues, see the 2008 *University of Illinois Federal Tax Workbook,* Chapter 14: Agricultural Issues and Rural Investments.

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

[162]. 11 USC §1222(A)(2)(a).

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2013 DEVELOPMENT — ANALYSIS OF *IN RE HEMANN*

In a bankruptcy court decision from Iowa in 2013,[163] the debtor and his brother formed an equal farm partnership in 1993 that owned livestock and machinery used in farming. The partnership dissolved in late 2010, and the debtor continued farming with a downsized farming operation. The debtor then filed under Chapter 12. Both the IRS and the state (Iowa) Department of Revenue filed priority claims for prepetition taxes arising from partnership dissolution that they treated as a sale of "partnership interests" rather than a sale of "farm assets." According to the claimants, this would not be entitled to nonpriority treatment in accordance with 11 USC §1222(A)(2)(a).

> **Observation.** The IRS has taken the position that only the sale of capital assets qualifies for nonpriority treatment under 11 USC §1222(a)(2)(A). Thus, asset sales that would be reported on Schedule F are not qualified for nonpriority treatment. The courts that have ruled on the issue have rejected the IRS position. However, no court (until the present case) had addressed the issue of the status of the sale of a partnership interest in the context of 11 USC §1222(A)(2)(a).

The debtor's expert witness attempted to characterize the debtor's partnership as not a partnership for tax purposes due to the small partnership exception of IRC §6231(a)(1)(B). Thus, according to the expert, the debtor's partnership was to be treated as nonexistent. That meant, according to the debtor's expert, that the debtor's income arose from the sale of a personal interest in a farm partnership rather than a capital interest in the partnership and qualified as the sale of a "farm asset" for purposes of 11 USC §1222(A)(2)(a). However, the court rejected the testimony of the defendant's expert witness as irrelevant and stated, ". . . the decision here will not rely in any way on his testimony."

> **Note.** If a partnership is required by IRC §6031(a) to file a partnership tax return, it is subject to rules enacted under the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982. An exception exists for a "small partnership" unless an election is made to have the TEFRA rules apply. To qualify for the small partnership exception for tax years ending after August 5, 1997, the partnership must meet the following conditions (to be determined annually).
>
> 1. Have no more than 10 partners at any time during the tax year (husband and wife and their estates count as one partner)
> 2. Each partner must be an individual, C corporation, or an estate of a deceased partner
> 3. The partnership must not have made an election to have the TEFRA rules apply
>
> If the exception applies, the penalty for failure to file a partnership tax return can be avoided. That penalty is $195 per partner (who was a partner for at least one day) per month late (for a maximum of 12 months). Even though the failure to file penalties can be avoided, it is still necessary that all items of income, deductions, and credit, etc. from the partnership are properly reported on a timely basis on the partners' individual tax returns. In addition, the partnership allocation percentages must be the same for all partnership tax attributes. In many instances, therefore, is will be much easier to simply report all of this information on a partnership tax return than to do the same calculations and then attempt to allocate individual items of income and expense to each partner. **As a result, the small partnership exception is far from a way to escape partnership tax complexity.**

The court noted that the small partnership exception enacted in 1982 as part of TEFRA implemented unified audit examination and litigation provisions, which centralized treatment of partnership taxation issues and ensured the equal treatment of partners by uniformly adjusting the tax liability of partners in a partnership. The court noted that there was a large amount of case law and legislative language contrary to the position of the debtor's expert. This included judicial opinions noting the effect of TEFRA and that the small partnership exception was to keep the old rules in place for small partnerships rather than create new ones.

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[163] *In re Hemann,* No. 11-00261, 2013 Bankr. LEXIS 1385 (Bankr. N.D. Iowa Apr. 3, 2013).

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Ultimately, the court determined that 11 USC §1222(A)(2)(a) applied to the sale of farm assets in general, including capital assets used in farming. Because the underlying assets that were sold were farm assets, they are covered by 11 USC §1222(A)(2)(a) as determined by the 8th Circuit in 2009.[164] The court noted that the U.S. Supreme Court decision in *Hall v. U.S.,*[165] did not overrule the 8th Circuit's decision on the issue of the definition of "farm assets" for purposes of 11 USC §1222(A)(2)(a). Instead, the debtor's farm partnership interest was "used in" the farming operation. In other words, the debtor farmed by using the farm partnership interest. Also, the court held that 11 USC §1222(A)(2)(a) was not limited in its application to the farming operation under the reorganization plan. Because the debtor met all of the other requirements for Chapter 12 bankruptcy, the defendants' objections to the debtor's confirmed Chapter 12 plan were overruled.

Note. The IRS did not appeal the bankruptcy court's decision.

ESTATES AND TRUSTS: PASSIVE LOSSES AND PARTICIPATION TESTS

The Tax Reform Act of 1986[166] created the passive loss rules,[167] which were enacted to stop individuals from using tax shelters to reduce income tax liabilities. Prior to the 1986 act, many tax shelters were designed to generate tax losses that were currently deductible by the investors without the investors incurring any actual economic losses.

The passive loss rules limited the use of these shelters by capping the deductible amount of passive losses to the amount of income claimed from passive activities.[168] They also limited the amount that taxpayers could claim for most tax credits generated by passive activities to the amount of tax incurred on passive activities. In addition, the regulations added a requirement for certain activities to be treated as nonpassive even though they were, by definition, passive.[169]

MATERIAL PARTICIPATION TESTS

An activity is considered a passive activity and the passive loss rules are invoked if the activity involves a trade or business and the taxpayer does **not** materially participate in the activity "on a basis which is regular, continuous and substantial." Therefore, in order to deduct losses from trade or business activities, the taxpayer must materially participate in the activity. As mentioned previously, the issue for trusts and estates is defining who the taxpayer is for purposes of meeting this test.

Although IRS regulations set forth several material participation tests for individual taxpayers, the IRS has never issued regulations addressing the material participation requirement for nongrantor trusts or estates. For pass-through entities, material participation is determined with respect to each member of the entity, with reference to the tax year of the entity. For closely held C corporations and personal service corporations, material participation is generally required by shareholders with aggregate ownership of more than 50% in value of the corporation's outstanding stock. In addition, C corporations (but not personal service corporations) meet the test if the corporation's business activities are exempt from the at-risk rules under IRC §465(c)(7), which attributes the activities of employees to the corporation.

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

165. 132 S. Ct. 1882 (2012).

166. PL 99-514, §501(a), 100 Stat. 2233 (1986), adding IRC §469.

167. IRC §469.

168. Ibid.

169. Temp. Treas. Reg. §1.469-2T(f).

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OVERVIEW OF KEY ISSUES TO DETERMINE PARTICIPATION LEVELS

Estates

For the tax years of an estate that end less than **two years** after the decedent's date of death, the standard for rental real estate activities is **active participation of the decedent** before death.[170]

For activities other than rental real estate, the Code is silent for estates (as it is for trusts) on whose activity determines whether the **material participation** test has been satisfied.

Grantor Trusts

Grantor trusts are **not** subject to the passive activity loss rules.[171] Instead, the grantor, personally, is subject to the rules, and it is the **grantor's active or material participation** that is the key.[172] Whether the participation standard is active or material depends on the type of passive activity.

Nongrantor Trusts

As mentioned earlier in this chapter, the primary issue for a nongrantor trust for purposes of the passive loss rules is determining who the **taxpayer** is. The statute defines a taxpayer as any individual, estate, or trust;[173] any closely held C corporation;[174] or any personal service corporation.[175]

Generally, there is no **active participation standard** for nongrantor trusts engaged in rental real estate activities. However, certain trusts may elect to be treated as part of an estate during the first two years after the death of the individual for whom the trust was considered a revocable grantor trust prior to death.[176] Therefore, during this period, if the **decedent** actively participated in the activity prior to death, the electing trust may still deduct rental property losses under the exception for individuals.[177]

Thus, although the Code is clear that a trust (rather than a trustee) is the taxpayer whose **material participation** is decisive, the statute is silent on **how** to determine whether the material participation test has been satisfied. Because the trust can only act through other people to satisfy the material participation test, it is important to determine who the key people are whose activity counts.

The longstanding IRS position has been that **only the trustee** of a trust can satisfy the material participation test. Although that position was rejected by a federal court in 2003, the IRS has continued to maintain its position with pronouncements in 2007, 2010, and 2013.

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170. Ibid.

171. Temp. Treas. Reg. §1.469-1T(b)(2).

172. See Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 242, n. 33, 100th Cong., 1st.

173. IRC §469(a)(2)(A).

174. IRC §469(a)(2)(B).

175. IRC §469(a)(2)(C).

176. Treas. Reg. §1.645-1(e)(2).

177. IRC §469(i)(4)(A).

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2003 CASE

Mattie K. Carter Trust v. U.S.[178] involved a testamentary trust established in 1956. A trustee, who had served since 1984, managed the trust assets, including, initially, a one-half interest in a ranch that the trust had operated since 1956. The trust acquired the balance of the ranch in 1992 upon the death of Mattie's husband. The ranch consisted of 15,000 acres and included cattle ranching operations in addition to oil and gas interests. The trust employed a full-time ranch manager and other employees who conducted essentially all of the ranch's activities. The trustee also devoted a great deal of time and attention to ranch activities. The trust claimed deductions for losses it incurred in connection with the ranch operations for 1994 and 1995 of $856,518 and $796,687, respectively. In 1999, the IRS issued a deficiency notice disallowing the deductions because of the passive loss rules.

The issue before the court was whether the trust materially participated in the ranching operations or was otherwise passively involved. The IRS conceded during trial that its existing regulations[179] applied only to individuals.[180] Furthermore, the IRS could not cite any case law to support its position, instead relying on what the court referred to as a **snippet** of legislative history that states, "an estate or trust is treated as materially participating in an activity . . . if an executor or fiduciary, in his capacity as such, is so participating."[181] However, that language simply restates the obvious and does not say that a fiduciary's participation is the **only** way a trust can satisfy the material participation test. The trust's representative, on the other hand, maintained that the trust was the taxpayer, not the trustee, and that material participation should be determined by assessing the trust's activities through its fiduciaries, employees, and agents. The representative also maintained that, as a legal entity, the trust could participate only through the actions of those individuals. Their collective efforts on the ranching operations during 1994 and 1995, the representative argued, were regular, continuous, and substantial.

The court agreed with the trust's position and noted that the IRS's argument that the trust's participation in the ranch operations should be measured by referring to the trustee's activities had no support within the plain meaning of the statute.[182] Because the statute was clear on the matter, legislative history was irrelevant. The court stated that the IRS's view was "arbitrary, subverts common sense, and attempts to create ambiguity where there is none."

Observations

1. The court ruled that the trust's participation in the ranch operations involved an assessment of the activities of those who labored on the ranch or otherwise conducted ranch business on the trust's behalf. Their **collective activities** during the times in question were regular, continuous, and substantial enough to constitute material participation.
2. The IRS did not appeal the court's decision in this case. However, the court also found that the trustee, alone, satisfied the material participation test. Therefore, an appeal would have had to refute that finding. It probably would not have addressed the issue of whether the activity of persons other than the trustee also counted toward the material participation test.

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178. *Mattie K. Carter Trust v. U.S.,* 256 F.Supp. 2d 536 (N.D. Tex. 2003).
179. Temp. Treas. Reg. §1.469-5T.
180. Indeed, a subsection in the temporary regulation has been reserved for material participation by trusts and estates, but has never been promulgated. See Temp. Treas. Reg. §1.469-5T(g).
181. S. Rep. No. 99-313, 99th Cong., 2d Sess. 735 (1986).
182. IRC §469(a)(2)(A).

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Additional Developments

- **2007 Tech. Advice Memo.** In an undated Technical Advice Memorandum (TAM)[183] released on August 17, 2007, the IRS again took the position that a trust satisfies the material participation test only if the fiduciary is involved in the operations of the trust's business activities on a regular, continuous, and substantial basis. Under the facts of the TAM, a testamentary trust acquired an interest in an LLC. The trustees provided services to the LLC encompassing a range of administrative and operational activities for the LLC's business. The will establishing the trust provided for the appointment of special trustees for part or all of the trust property. A contract between the trust and the special trustees stated that the special trustees' involvement in the LLC's business is intended to satisfy the material participation test requirement under the passive loss rules. The special trustees reviewed operating budgets, analyzing a tax dispute, preparing and examining financial documents and negotiating the sale of the trust's interests in the LLC to a new partner. However, ultimate decision-making authority remained solely with the trustees.

  The IRS restated its disagreement with the *Mattie K. Carter Trust* decision,[184] holding firm to its position that only the trustee can satisfy the test. The IRS determined that the special trustees did not have the discretionary power to act on behalf of the trust, even though they were deeply involved in the trust's business activity. As such, the trustees' involvement in the business was not regular, continuous, and substantial, and the trust did not materially participate in the LLC's business.

- **2010 Letter Ruling.** In a letter ruling released in late July of 2010, the IRS again took the position that the only way a trust can establish material participation under the passive loss rules is through the trustee.[185] According to the IRS, the trustee must be involved in the operations of the activity on a regular, continuous, and substantial basis. In the ruling, the IRS did not even refer to the *Mattie K. Carter Trust* case[186] or, for that matter, the 2007 TAM. Instead, the IRS based its entire rationale on the "snippet" of legislative history that the court in *Mattie K. Carter Trust* had deemed irrelevant.

- **2013 TAM.** In a TAM released in late April of 2013,[187] the IRS continued to reiterate its position that the only way a trust can satisfy the material participation test is through the trustee's participation in the trust's activity as the trustee. The facts involved two trusts that each had an interest in an S corporation, with the balance of the interests in the S corporation owned by the taxpayer. The S corporation owned another corporation that was a qualified subchapter S subsidiary of which the taxpayer was the president and was directly involved in daily operations. The trusts had income from their interests in the S corporation. The taxpayer, the taxpayer's spouse, children, and grandchildren were all beneficiaries of the trusts. The taxpayer was a special trustee of the trusts and controlled all of the decisions regarding the disposition of the S corporation stock and the voting of that stock. However, the taxpayer was not able to distinguish between time spent conducting business as the corporate president and time spent as the special trustee. The IRS took the position that the trusts did not materially participate in the S corporation business. As a result, according to the IRS, in computing alternative minimum taxable income, the trusts' share of research or experimental expenses incurred by the S corporation had to be amortized over 10 years. The IRS claimed that only the participation of the taxpayer as the trustee of the trusts acting in a fiduciary capacity counted toward the material participation test. The IRS would not allow the taxpayer to count any time spent participating in the trust business as corporate president. The IRS ignored the interrelated role of the taxpayer as special trustee and corporate president for purposes of the material participation test.

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183. TAM 200733023 (Aug. 17, 2008).

184. *Mattie K. Carter Trust v. U.S.,* 256 F.Supp. 2d 536 (N.D. Tex. 2003).

185. Ltr. Rul. 201029014 (Apr. 7, 2010).

186. *Mattie K. Carter Trust v. U.S.,* 256 F.Supp. 2d 536 (N.D. Tex. 2003).

187. TAM 201317010 (Jan. 18, 2013).

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Observations.

1. TAMs and letter rulings are not substantial authority. However, they do signal the position that the IRS will take in an audit.
2. The IRS has never issued regulations addressing the issue of material participation for trusts and estates. In fact, a subsection in Temp. Treas. Reg. §1.469-5T is reserved for this issue, but the subsection has never been promulgated.
3. At the time this book was published, the U.S. Tax Court was expected to rule on a case involving the issue of how a trust can satisfy the material participation test.[188] The final briefs in the case were filed in October 2012.[189] The IRS has argued that only individuals and C corporations can qualify for the special passive activity loss exceptions for real estate operators.[190]
4. The IRS position will make it very difficult, if not impossible, for trusts to avoid the new (as of 2013) 3.8% NIIT.[191] As explained earlier in this chapter, the NIIT threshold for trusts is $11,950 (according to the IRS, although the statute is not clear) for 2013.[192]

188. *Frank Aragona Trust v. Comm'r*, No. 15392-11 (filed Jun. 29, 2011).

189. *Docket Inquiry — Index*. United States Tax Court. [www.ustaxcourt.gov/UstcDockInq/DocketDisplay.aspx?DocketNo=11015392] Accessed on Jul. 23, 2013.

190. [www.irs.gov/pub/irs-wd/1244017.pdf] Accessed on Jul. 23, 2013.

191. IRC §1411.

192. Rev. Proc. 2013-15, 2013-5 IRB 444.

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