Chapter 4: Agricultural Issues and Rural Investments

Corrections were made to this workbook through January of 2015. No subsequent modifications were made.

THE AFFORDABLE CARE ACT AND AGRICULTURAL PRODUCERS

REQUIREMENT THAT LARGE EMPLOYERS OFFER HEALTH INSURANCE

Under the Affordable Care Act (ACA), an applicable large employer (ALE) must offer health insurance to its employees. An **ALE** is defined as one that employed an average of at least **50 full-time equivalent (FTE)** employees during the preceding calendar year.[1] For this purpose, related entities are treated as a single employer in accordance with IRC §414 qualified retirement plan aggregation rules.

A full-time employee is an individual employed an average of **at least 30 hours per week.** The number of FTE employees for any month is determined by dividing the aggregate number of service hours of employees who are not full-time for the month by 120.[2]

The employer is not considered an ALE if the number of full-time employees plus FTE employees exceeds 50 for no more than 120 days during the year, and the employees in excess of 50 were seasonal employees.[3] For this purpose, a seasonal worker is one who performs labor or services on a seasonal basis, as defined by the Secretary of Labor.

The 2015 mandate for employers that have 100 or more employees requires that they offer health insurance coverage to at least 70% of eligible employees. The percentage increases to 95% for 2016 and later years. For employers with 50–99 employees, the employer mandate is delayed until 2016.[4] Employers will use information about the number of employees they employ and their hours of service during 2014 to determine whether they are considered an ALE for 2015. A **small employer** (one with fewer than 50 FTE employees) is not required to offer health insurance.

1. IRC §4980H(c)(2)(A).
2. IRC §4980H(c)(2)(E).
3. IRC §4980H(c)(2)(B)(i).
4. *Questions and Answers on Employer Shared Responsibility Provisions under the Affordable Care Act.* May 13, 2014. [www.irs.gov/uac/Newsroom/Questions-and-Answers-on-Employer-Shared-Responsibility-Provisions-Under-the-Affordable-Care-Act] Accessed on Jul. 14, 2014.

There are penalties that apply to ALEs. The penalty for failing to provide coverage to full-time employees when required applies if at least one employee receives a **premium tax credit** (PTC)[5] or other cost subsidy because insurance is not offered or the insurance offered is unaffordable. **Affordability** is determined based on the employee's household income (but the employer may rely on the employee's income reported on Form W-2, *Wage and Tax Statement.)* The PTC is not available if an employee's income exceeds 400% of the federal poverty level. If no insurance is offered when it is required, the penalty is $2,000 per employee. For 2015, there is no penalty on the first 80 employees. If inadequate insurance is offered, the penalty is $3,000 per employee, but the total penalty cannot exceed the penalty that would have applied if no insurance had been offered.

Note. For more information about the employer mandate, see the 2014 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Affordable Care Act Update.

Single Employer Common Control Test and Constructive Ownership

It is necessary to determine whether related organizations must be treated as a single employer for purposes of meeting various ACA requirements. A multiple-entity farming structure whose companies were established under separate tax identification numbers is treated as a single employer under the controlled group rules of IRC §414.

If two or more entities are owned by five or fewer persons who own more than 50% of the total combined voting power or more than 50% of the stock value, the ownership structure of the entities must be examined. For this purpose, an individual is deemed to own the stock of their spouse and minor children. An individual who owns more than 50% of the voting power or stock value is considered to own the stock of their lineal ancestors and descendants.[6] However, the ownership interests of siblings are not included. Consider the following examples.[7]

Example 1. Bob owns 65% of FarmCo and 50% of LandCo. Bob's daughter, Julia, owns 35% of FarmCo and 50% of LandCo. Because Bob owns more than 50% of FarmCo, Julia's ownership is attributed to him. As a result, Bob is deemed to own 100% of FarmCo. However, because neither Bob nor Julia owns more than 50% of LandCo, there is no attribution for that entity.

Example 2. Bob owns 100% of FarmCo and 50% of LandCo. Julia owns 50% of LandCo but none of FarmCo. Because Bob and Julia's common ownership does not exceed 50%, each company is recognized as a separate employer.

Example 3. Bob owns 100% of FarmCo, Julia owns 100% of LandCo, and both Bob and Julia own 50% of MachineCo. Because there is no ownership combination resulting in common ownership in excess of 50%, there is no attribution.

CREDIT FOR SMALL EMPLOYER HEALTH INSURANCE PREMIUMS

For 2014 and 2015, a credit of 50% (35% in 2013) is available to offset the cost of providing insurance coverage to employees.[8] The credit is claimed on Form 8941, *Credit for Small Employer Health Insurance Premiums,* and is calculated by applying the percentage to employer-paid insurance premiums and is subject to phaseout limits based on the number of FTE employees and wages paid. The full amount of the credit is available if the number of FTE employees does not exceed 10. The credit is reduced if the employer has between 11 and 24 FTEs and is unavailable once the number of FTE employees reaches 25.

5. IRC §4980H(b)(1).

6. IRC §318.

7. The examples are adapted from a presentation by Chris Hesse of CliftonLarsonAllen at the AICPA Agriculture Conference, Austin, TX, May 8, 2014.

8. The credit is 25% for a tax-exempt small employer. See IRC §45R(g)(2).

In addition, the full amount of the credit is available if average wages do not exceed $25,000. A reduced credit is available if average wages are between $25,000 and $50,000 and is unavailable if the average wages equal or exceed $50,000.

Each of the phaseout computations is applied separately to the gross amount of the credit. Due to the phaseouts and stringent eligibility rules, the credit has limited ability to assist small employers who provide health insurance.

Note. For a detailed example showing how the credit is calculated and claimed, see the 2012 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 2: Credits. This can be found at **www.taxschool.illinois.edu/taxbookarchive/.**

Starting in 2014,[9] the employer must purchase insurance through the Small Business Health Options Program (SHOP) exchange in order to be eligible for the credit. It is only available for the first two consecutive taxable years.[10]

Note. Online enrollment through SHOP has been delayed until November 2014. Small businesses may still apply through a broker using a paper application. As of the date this book was published, proposed regulations would allow employers that enroll in a SHOP plan before the end of 2014 to be eligible for the tax credit retroactive to the beginning of the tax year.

A self-employed farmer can deduct the cost of their health insurance premiums when computing adjusted gross income (AGI). Beginning in 2014, self-employed persons may be eligible for the PTC, which is based on the taxpayer's income and family size. For larger families, the PTC may be available even when income levels are near six figures. The PTC is also based on AGI. Because the self-employed health insurance deduction is allowed in computing AGI and AGI is used in computing the PTC, the taxpayer must know the allowable self-employed health insurance deduction to compute the PTC.

The IRS issued Rev. Proc. 2014-41 to provide calculation methods that are designed to resolve the circular relationship. An example in the Rev. Proc. illustrates a married couple with two dependent children and earned income of $75,000 who are enrolled in the second-lowest-cost silver plan, with an annual premium of $14,000. Under 2013 law, the taxpayer would pay $14,000 and deduct the entire amount. However, with the change in the law effective beginning in 2014, the outcome is different, with the result that the taxpayer could claim a self-employed health insurance deduction of approximately $6,000 and a PTC of almost $7,000.

Year	Calculation	Tax Savings
2013	$14,000 × 25% tax rate	$3,500
2014	($6,000 × 25%) + $7,000 PTC	8,500

9. *Small Business Health Care Tax Credit for Small Employers.* [www.irs.gov/uac/Small-Business-Health-Care-Tax-Credit-for-Small-Employers] Accessed on Jul. 3, 2014.

10. IRC §§45R(b)(1) and (e)(2).

Form 8941

FTEs reported on Form 8941, *Credit for Small Employer Health Insurance Premiums,* require different calculations than FTEs reported for purposes of the employer mandate. The following persons are not counted in the determination of FTEs on Form 8941.

1. Seasonal workers (unless the seasonal worker works for the employer for more than 120 days during the tax year)
2. Sole proprietors
3. Partners in the partnership
4. Shareholders owning more than 2% of an S corporation
5. Any owner of more than 5% of a business
6. Family members (i.e., lineal descendants, sibling or step-sibling, parent or parent's ancestor, step-parent, niece or nephew, aunt or uncle, son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, sister-in-law) of any person described in items 2-5 above.

The instructions allow the business to calculate the average wages using three different methods. **The business can use a different method to calculate the number of hours worked for each employee.**

There are three different calculations which may be used to determine the most advantageous Form 8941 tax credit for the employer. These methods include basing the calculations on the actual hours worked, the actual days worked, or the actual number of weeks worked. Each of these calculations should be evaluated to determine the best alternative for the taxpayer.

The three methods that can be used are as follows.

1. **Actual hours worked** (This method includes hours paid due to vacation, holidays, etc.)
2. **Days-worked equivalency** (This method credits the employee with eight hours of service for each actual workday in which the employee is credited with at least one hour of service. Workdays include vacation days, holidays, etc.)
3. **Weeks-worked equivalency** (This method credits the employee with 40 hours of actual weekly service for each week in which the employee is credited with at least one hour of service.)

Example 4. Ben Farmer has five employees in 2014. The employees' wages and hours worked are as follows.

Employee	Days Worked	Actual Hours	Weeks Worked	Wages
1	234	2,160	52	$ 41,331
2	260	1,814	52	23,628
3	253	2,102	50	30,845
4	200	999	52	14,513
5	55	329	12	8,215
Total				$118,532

Employee number 5 is a seasonal employee, so their wages and hours of service are not included in the calculations. By choosing the most advantageous means of calculating the hours of service, this employer is able to count all four eligible employees as FTEs. The average wage is then calculated by dividing the total eligible wages by the FTEs, reducing the average rounded wage to $27,000 (($41,331 + $23,628 + $30,845 + $14,513) ÷ 4).

Employee	Hours of Service: Actual Hours	Based on Days Worked	Based on Weeks Worked	Hours Used to Compute FTE
1	**2,080** [a]	1,872	**2,080**	**2,080**
2	1,814	**2,080**	**2,080**	**2,080**
3	**2,080**	2,024	2,000	**2,080**
4	999	1,600	**2,080**	**2,080**
5 (seasonal, not included in totals)	N/A	N/A	N/A	N/A
Total	6,973	7,576	8,240	8,320
Divided by 2,080	3.35	3.64	3.96	4.00
FTE	3	3	3	4
Average wage ($110,317 ÷ FTE)	$36,772	$36,772	$36,772	$27,579
Rounded average wage	$36,000	$36,000	$36,000	$27,000

[a] Actual hours worked are capped at 2,080.

The credit phaseout is reduced by the amount of wages in excess of $25,000.

If Ben used the same method to compute the average wages for all his employers (i.e., actual hours worked, days-worked equivalency, or weeks-worked equivalency), his credit would be reduced by 44% (($36,000 – $25,000) ÷ $25,000).

However, because Ben chooses the most advantageous method to calculate the average wages of each employee, his credit is only reduced by 8% (($27,000 – $25,000) ÷ $25,000).

HEALTH REIMBURSEMENT PLANS (HRP)

Federal law has long granted employers several options to provide tax-advantaged health accounts to their employees. In 2014, the ACA significantly affected these choices, particularly for HRPs, which include health reimbursement arrangements (HRA), healthcare flexible spending accounts (FSA), and employer payment plans.[11]

Health Reimbursement Arrangements (§105 Plans)

Health reimbursement arrangements (HRA), also known as health reimbursement accounts, are employer-established accounts authorized by IRC §§105 and 106. For this reason, HRAs are sometimes called §105 plans. HRAs cannot be **funded by voluntary employee salary reductions.** Rather, they must be solely funded by the employer. The employee is then reimbursed tax-free from these funds (up to a maximum dollar amount each coverage period) for qualifying medical expenses incurred by the employee or their family. These qualifying medical expenses can include health insurance premiums.

An employer can also establish an HRA for a retired employee or for the spouse or dependents of a deceased employee. The funds paid into an HRA by an employer are not taxed to the employee because §105 excludes from an employee's gross income any money paid by an employer to reimburse the employee for medical care expenses.[12]

HRAs have been particularly popular among small businesses, organizations, and farming operations wishing to offer healthcare benefits to their employees. These employers, often not positioned to purchase affordable group coverage, could use an HRA to reimburse their employees tax-free for health insurance premiums paid by the employees.

11. PL 111-148, §2702, 124 Stat. 119, 318-319 (2010), amended by the Health Care and Education Reconciliation Act (HCERA), PL 111-152.

12. IRC §105(b).

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ACA Impact on HRPs

In late 2013, two federal agencies tasked with implementing the ACA — the Department of the Treasury (IRS) and the Department of Labor — issued *Application of Market Reform and other Provisions of the Affordable Care Act to HRAs, Health FSAs, and Certain other Employer Healthcare Arrangements.*[13] This guidance clarifies the significant impact the ACA has on popular healthcare reimbursement plans. These changes, for the most part, became effective January 1, 2014.

The guidance first establishes that account-based reimbursement plans are generally **group health plans.**[14] As such, most of these plans are subject to the healthcare insurance market reform rules of the ACA, which means that a number of them will violate the law. The penalty for violating these rules is $100[15] per day per employee ($36,500 per employee per year).

The following plans are specifically excepted from the ACA requirements.

- Plans with **fewer than two participants** who are current employees[16]
- Plans that **provide only excepted benefits,**[17] including:
  - Accident-only coverage
  - Disability income
  - Certain limited-scope dental and vision benefits
  - Certain long-term care benefits
  - Benefits under an employee assistance program, if the program does not provide significant benefits in the nature of medical care or treatment[18]
  - Healthcare FSAs in which the employer offers other group health insurance coverage and the maximum benefit payable to an employee does not exceed the greater of two times the employee's salary reduction election for the year, **or** $500 plus the amount of the participant's salary reduction election

Note. Under the ACA, a group health plan may not place any annual limit on the dollar amount of benefits for any individual.[19] The group plan can only place an annual limit, for an individual, on certain nonessential health benefits. The ACA also requires group health plans to provide a host of preventive services, such as vaccinations and colonoscopies, without a cost-sharing requirement (such as a co-payment).[20]

13. IRS Notice 2013-54, 2013-40 IRB 287; and DOL Technical Release 2013-03. (These two releases are the same.)
14. Ibid.
15. IRC §4980D.
16. IRC §9831(a)(2); and ERISA §732(a).
17. IRC §9831(b); ERISA §732(b); and PHS Act §§2722(b) and 2763.
18. IRS Notice 2013-54, 2013-40 IRB 287 (answer to Question 9; rulemaking still pending).
19. PHS Act §2711.
20. PHS Act §2713.

An employer-provided HRP, even though it may violate the preventive services and annual dollar limit requirements of the ACA when considered by itself, can be integrated with an employer-sponsored group health plan that abides by ACA market reforms.[21] In such cases, the HRP will also comply with the ACA. However, an employer-sponsored plan cannot be integrated with individual market coverage, even if that coverage is purchased from the health insurance exchange marketplace.

Observation. Consequently, most **standalone** HRPs, unless they offer excepted benefits only, violate the ACA.

The guidance from the IRS and the Department of Labor specifically states that as of January 1, 2014, an HRA must either provide only "excepted benefits" or be integrated with an ACA-compliant employer-sponsored group health plan (or another compliant group health plan meeting one of the integration methods explained later). An employer cannot establish an HRA to allow employees to purchase health plans on the individual market (even from the marketplace). The guidance also explains that because HRAs are considered group health plans under the ACA, they are treated as minimum essential coverage for employees (unless they provide only excepted benefits) and prevent covered employees from obtaining premium subsidies when purchasing insurance on the marketplace.[22]

Note. For an explanation of minimum essential coverage, see the 2014 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Affordable Care Act Update.

The guidance explains that a standalone HRA offering nonexcepted benefits would violate the ACA because an employer payment plan is considered to impose an annual limit up to the cost of the individual market coverage purchased through the arrangement, thereby violating the annual dollar limit prohibition. Furthermore, the guidance clarifies that a standalone HRA would fail to comply with the preventive services requirements of the ACA because it "does not provide preventive services without cost-sharing in all instances."[23]

The guidance does provide two specific ways in which an HRA can be integrated with another group plan, one with no minimum value required and one with a minimum value required.

No Minimum Value Required. According to the guidance, an HRA is integrated with another group health plan for both the annual dollar-limit prohibition and the preventive services requirements if all of the following conditions are met.[24]

- The employer offers a group health plan (other than the HRA) to the employee that does not consist solely of excepted benefits.
- The employee receiving the HRA is enrolled in a group health plan (other than the HRA) that does not consist solely of excepted benefits, regardless of whether the employer sponsors the group plan.
- The HRA is available only to employees who are also enrolled in non-HRA group coverage, regardless of whether the employer sponsors the non-HRA group coverage. (For example, the non-HRA group coverage may be sponsored by the employer of the employee's spouse.)
- The HRA is limited to reimbursement of one or more of the following: co-payments, co-insurance, deductibles, and premiums under the non-HRA group coverage, as well as medical care that does not constitute essential health benefits.[25]

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21. IRS Notice 2013-54, 2013-40 IRB 287.

22. Ibid.

23. Ibid.

24. Ibid.

25. The essential health benefits mandated by the ACA include ambulatory patient services; emergency services; hospitalization; maternity and newborn care; mental health and substance use disorder services, including behavioral health treatment; prescription drugs; rehabilitative and habilitative services and devices; laboratory services; preventive and wellness services and chronic disease management; and pediatric services, including oral and vision care.

- Under the terms of the HRA, an employee may permanently opt out and waive future reimbursements from the HRA at least annually. Upon termination of employment, either the remaining amounts in the HRA are forfeited or the employee is permitted to permanently opt out and waive future reimbursements from the HRA.[26]

Note. This means that an employee can choose to be enrolled in the group health plan (that provides essential health benefits) of their spouse's employer and still be entitled to coverage through their own employer's HRA if the employer also offers a group health plan that provides essential health benefits. The employee must attest to their employer that the HRA benefits will be used solely to pay co-payments, co-insurance, deductibles, or premiums under the health plan of their spouse's employer or to pay for medical care that is not an essential health benefit.

Minimum Value Required. An HRA may be integrated with another group health plan for both the annual dollar-limit prohibition and the preventive services requirements if the following conditions are met.

- The employer offers its employees a group health plan designed to pay at least 60% of the total cost of medical services for a standard population (providing minimum value).[27]
- The HRA-covered employee is enrolled in a group health plan providing minimum value. (This plan need not be sponsored by the employer, but may be sponsored by another provider, such as a spouse's employer.)
- The HRA is only available to employees enrolled in minimum value group coverage.
- An employee (or former employee) may permanently opt out and waive future reimbursements from the HRA at least annually. Upon employment termination, either the remaining amounts in the HRA are forfeited or the employee may permanently opt out and waive future HRA reimbursements.[28]

Note. This means that an employee can enroll in minimum value group coverage sponsored by their spouse's employer and attest to their employer that they are covered by another group plan providing minimum value. Even though the two employers are not treated as a single employer, the minimum value group plan from the spouse's employer and the employer's HRA are integrated for both the annual dollar-limit prohibition and the preventive services requirements.

There are **exceptions to the ACA** market reform mandates as applied to HRAs. Although one-employee plans are exempt (the typical situation for a husband-wife sole proprietorship farming operation when the spouse is employed in the business), nondiscrimination rules apply, and the benefits are taxable if those rules are violated. In testing for discrimination, the following employees are disregarded.

- Employees with fewer than three years of service
- Employees who have not attained age 25
- Seasonal employees (generally, those who work less than seven months per year)
- Part-time employees (generally, those who work fewer than 25 hours per week)

In addition, **ancillary benefit plans** are also exempt. These plans cover dental, vision, long-term care premiums, or disability premiums. However, ancillary plans cannot cover health insurance, co-payments, and hospital and doctor deductibles.

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26. An employee must be allowed to opt out, because benefits provided by an HRA generally constitute "minimum essential coverage," meaning that the employee (if covered by the HRA) would be unable to claim an IRC §36B premium tax credit for insurance purchased on the marketplace.

27. IRC §36B(c)(2)(C)(ii).

28. IRS Notice 2013-54, 2013-40 IRB 287.

Employer Health Plans

IRC §105 plans can be integrated with group health coverage. The coordinated coverage must meet the ACA market reforms, and each participant in the HRA must be enrolled in the health insurance plan.[29]

The following types of employer health plans **violate the market reform rules** and are **subject to the $100 per-day per-employee penalty.**

- Standalone §105 medical reimbursement plans
- Employer payment of individual health insurance premiums
- §125 salary-reduction plans for employee health insurance premiums

The following types of employer health plans are permitted.

- ACA-approved group health plans
- ACA-approved group health plans with a high-deductible health plan (HDHP)
- Group health plans acquired through the SHOP exchange (The SHOP plan may then allow for §125 salary-reduction arrangements and may also qualify the employer for the small employer health insurance premium credit.)

Fees for Self-Insured Health Plans.[30] The ACA imposes an additional fee on employers that sponsor a self-insured health plan (i.e., any plan that provides accident and health coverage other than through an insurance policy). The following plans are subject to the fee.

- Self-insured plans for medical reimbursement
- Prescription drug plans
- Self-insured dental or vision plans, if provided without a separate election or premium charge
- HRAs
- Retiree-only health plans

The following plans are exempt from the additional fee.

- Separately insured dental or vision plans
- Self-insured dental or vision plans that are subject to separate coverage elections and employee contributions
- Expatriate coverage provided primarily for employees who work and reside outside of the United States
- HSAs
- Most FSAs
- Employee assistance programs that do not provide significant benefits in the nature of medical care or treatment

For single-employer plans, the **employer is responsible for the fee.** Organizations must pay the fee for plans established and maintained by an employer organization.

> **Note.** A similar fee is imposed on insurance plans that must be paid by the issuer of the insurance policy.

29. Ibid.

30. Treas. Reg. §46.4376-1.

The fee is computed by multiplying the average number of lives covered for the plan year by the applicable tax rate. For plan years ending between October 1, 2012, and September 30, 2013, the tax rate was $1. For plan years ending between October 1, 2013, and September 30, 2014, the tax rate was $2. For plan years ending on or after October 1, 2014, the tax rate will be based on the projected per-capita amount of national health expenditures.[31]

In determining the number of **lives covered**, an employer must count the employee and any family members who are covered under the medical reimbursement plan. The average number of lives covered can be determined in one of three ways.

1. **By actual count.** The employer determines the total lives covered for each day of the plan year and divides that total by the number of days in the plan year.
2. **By snapshot.** The number of lives covered is computed on a specific date during each quarter, then added together and divided by four.[32]
3. **By annually filing Form 5500.** The number of lives is derived from the total participants reported on Form 5500, *Annual Return/Report of Employee Benefit Plan,* at the beginning and end of the year and then divided by two.[33]

> **Note.** A special rule applies if an HRA is the only self-insured plan. In that case, the employer may count only the employee covered. (Family members are ignored.)

The fee is reported on Form 720, *Quarterly Federal Excise Tax Return,* and is due by July 31 of the calendar year immediately following the last day of the plan year. The fee is computed in part II of Form 720, which requires an entry for the average number of lives covered. That number is then multiplied by the tax rate, and the fee is remitted with the form.

The fee is deductible on Schedule F, *Profit or Loss From Farming.* Many farmers with medical reimbursement plans utilize a third-party administrator. For those farmers, the plan sponsor may complete Form 720. Farmers who administer their own group health plans are responsible for filing Form 720.

> **Note.** There is also a reinsurance program fee of $63 per enrollee.[34] The number of enrollees must be reported to the Department of Health and Human Services (HHS) by November 15, 2014, and HHS will bill the employer. This is an annual requirement through 2016.

Possible Alternative Solution. As an alternative to an HRA, a small employer may simply want to reimburse medical expenses of an employee as taxable wages. With this approach, the employer incurs social security and Medicare taxes, and the employee has taxable income and is subject to social security and Medicare taxes. In essence, a **fringe benefit that had been nontaxable to employees becomes taxable using this strategy.** This change could also affect other items on the employee's tax return.

31. See *National Health Expenditure Data.* Centers for Medicare & Medicaid Services. [www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/index.html?redirect=/nationalhealthexpenddata] Accessed on Jul. 14, 2014.

32. Under this approach, either the actual number of lives covered is used for each designated date, or the number of participants with self-only coverage is added to the number of participants with other than self-only coverage, multiplied by 2.35.

33. A plan with fewer than 100 participants generally need not file Form 5500. For more detail on the three methods, see Treas. Reg. §46.4376-1(c)(2).

34. 45 CFR Parts 146, 147, 148, 153, 155, 156, and 158.

Example 5. Frank operates a grain and cattle farm and employs Harry as one of several full-time employees. During 2013, Harry purchased an individual health insurance policy and paid a monthly premium of $350. Harry's wages are $500 per week. Frank reimbursed Harry for the $350 monthly premium in 2013. Under the rules existing in 2013, Frank is allowed to deduct the $4,200 ($350 × 12) annual reimbursement of Harry's health insurance premium, which is treated as a nontaxable fringe benefit for Harry. Harry's 2013 Form W-2 shows $26,000 ($500 weekly wage × 52 weeks) as wages in box 1.

In 2014, Harry continues his health insurance coverage, and Frank continues to reimburse the cost of the insurance. Because of the ACA changes to employer health reimbursement plans, Frank's reimbursement becomes taxable compensation to Harry. Harry's 2014 Form W-2 shows $30,200 ($26,000 cash wages + $4,200 insurance reimbursement) in box 1. The reimbursement also increases the FICA wages, and Frank and Harry each incur a $321.30 ($4,200 × 7.65%) increase in the FICA tax liability.

Frank is not subject to the $100-per-day penalty for violating the market reform rule because the reimbursement was added to cash wages.

HEALTH SAVINGS ACCOUNT

IRC §223 allows individuals (or employers on behalf of its employees) to make tax-favored contributions to an HSA. An HSA is a tax-exempt trust or custodial account established for paying qualified medical expenses (current or future) of the account beneficiary. An individual may have more than one HSA.

Eligibility

Individuals and their employers can contribute pretax dollars to an HSA, in which the contributed amounts can grow tax free. As long as the HSA funds are used to pay qualified out-of-pocket medical expenses, they are never subject to federal income tax. It is not necessary for a person to have earned income in order to contribute to an HSA.

To qualify, an individual must:

1. Be covered under an HDHP,

> **Note.** A **qualifying HDHP** is a healthcare plan that satisfies certain requirements for minimum deductibles and maximum out-of-pocket expenses. An HDHP is equivalent to a bronze plan offered through the marketplace. Bronze plans cover, on average, at least 60% of the cost of all benefits.

2. Have no disqualifying health coverage,[35]
3. Not be enrolled in Medicare,
4. Not have received Veterans Administration (VA) medical benefits within the prior three months, and
5. Not be eligible to be claimed as a dependent on another person's tax return.

An individual may keep their HSA if they become ineligible. (A person does not lose their HSA or the right to access the HSA by turning age 65 or by obtaining insurance with a low deductible.) However, further contributions cannot be made to the HSA unless the person once again becomes eligible.

35. IRS Notice 2013-57, 2013-40 IRB 293. However, other health coverage is permissible for persons with HSAs if the other coverage is for a specific disease or illness or is insurance for accidents, disability, dental care, vision care, or long-term care. Also, a person can have an HSA and remain eligible for VA benefits, unless VA benefits have actually been received in the prior three months.

An individual family member may have a separate HSA, provided that the eligibility rules are satisfied. The family member can also be covered through another family member's HSA. For example, a husband may use his HSA to pay his wife's expenses even though she has her own HSA. The cash contributions to an HSA can be made by eligible individuals as well as by other individuals or entities on their behalf. Thus, individuals may contribute to accounts of eligible family members, and employers may contribute to accounts of eligible employees. Employer contributions are not taxable income to the employee (although they count towards the annual contribution limitation).

Note. The tax advantages of HSAs can be significant. Contributions are deductible (or excluded from taxable income if contributions are made by an employer), withdrawals are not taxable if used for qualified medical expenses (as defined by IRC §213), and account earnings are tax-exempt. Unused balances are not lost at the end of the year and may accumulate without limit.[36] Contributions to an HSA can be made at any time during a calendar year and until the filing date (without extensions) for federal income tax returns, which is normally April 15 of the following year.

Limits

The applicable limits for HSAs are shown in the following table.

	2014 [37]		2015 [38]	
	Individual	Family	Individual	Family
Contribution limits [a]	$3,300	$ 6,550	$3,350	$ 6,650
Minimum deductible	1,250	2,500	1,300	2,600
Maximum out-of-pocket expense	6,350	12,700	6,450	12,900

[a] Eligible individuals who are age 55 but under age 65 may make additional catch-up contributions to their HSAs. The catch-up contributions may not exceed $1,000.

Withdrawals

Withdrawals from HSAs are tax-free if they are used to pay for qualified medical expenses that are incurred on or after the HSA is established. Tax-free withdrawals can be made for the qualified medical expenses of persons covered by the HDHP, the spouse of a covered individual (even if the spouse is not covered by the HDHP), and any dependent of a covered person (even if the dependent is not covered by the HDHP). Withdrawals not used for qualified medical expenses are included in gross income and are also subject to a penalty tax. Under the ACA, over-the-counter medicines (except insulin) are no longer considered qualified medical expenses; this change is effective for distributions made after 2010.

Note. The penalty for nonqualified distributions was 10%, but the ACA increased the penalty to 20% for distributions made in tax years beginning after 2010.[39]

36. Thus, an HSA can be a viable way to pay for medical costs for persons with pre-existing conditions who otherwise find health insurance difficult to obtain.

37. Rev. Proc. 2013-25, 2013-21 IRB 1110.

38. Rev. Proc. 2014-30, 2014-20 IRB 1009.

39. IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans.*

Preventive Care and the ACA

IRC §223(c)(2)(C) provides that a plan is accepted as an HDHP even if it does not have a preventive care deductible. HDHPs, therefore, can provide preventive care benefits without a deductible or with a deductible below the annual minimum otherwise required to be classified as an HDHP.[40] The ACA requires all group health plans to provide certain preventive health services without a cost-sharing requirement.[41]

FINAL REGULATIONS ON THE NET INVESTMENT INCOME TAX[42]

The net investment income tax (NIIT) is a 3.8% additional tax on net investment income (NII) for individuals with AGI above a threshold level. The **threshold levels,** which are not subject to inflation indexing, are:

- $200,000 for single and head of household (HoH) taxpayers,
- $250,000 for married couples filing jointly (MFJ) and qualifying widows and widowers, and
- $125,000 for married couples filing separately (MFS).

NII for this purpose includes the following.

- Interest
- Dividends
- Nonqualified annuity distributions
- Rents
- Royalties
- Passive income from a trade or business activity
- Income from the trade or business of trading in financial instruments
- Income from the trade or business of trading in commodities
- Gains from the sales of assets (unless associated with trade or business income for a materially participating taxpayer)

Certain deductions are allowed to reduce NII. Final regulations (along with new proposed regulations) were issued in late November 2013.[43]

Note. For more information about the calculation of the NIIT and NII, see the 2014 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Affordable Care Act Update.

40. IRS Notice 2013-57, 2013-40 IRB 293.
41. PHS Act §2713.
42. IRC §1411.
43. TD 9644, 2013-51 IRB 676.

Self-Rentals and Grouped Rentals

Many farming operations involve the rental of an asset (or assets) to another entity in which the taxpayer materially participates. Under the final regulations, any rent income that is classified as nonpassive under either of the following provisions is not considered investment income.

1. Self-rental income (rents received by a taxpayer from property that is rented for use in a trade or business activity in which the taxpayer materially participates)
2. Property properly grouped as an economic unit under the provisions of Treas. Reg. §1.469-4(d)(1)

Any resulting gain from asset sales from either of these activities is not considered investment income. Under the final regulations, if the rental property was properly grouped with a materially participating activity **or** if it was self-rental property, none of the gain is subject to the NIIT.

Note. Rental income is passive for NIIT purposes. However, the self-rental rule is important in agriculture and allows rental activities to be structured to avoid the NIIT in many situations. Custom farming arrangements result in passive income to the landowner. The activity of the agent (farm management company or other individual that is farming the land) is not imputed to the landowner for purposes of IRC §469. To avoid having the rental income being subject to the NIIT, the landowner must materially participate.

Example 6. Able Farmer operates his farm as a sole proprietorship and rents land from LandCo LLC, which he owns with his wife. The cash-rent income that flows from the LLC is considered nonpassive income to Able because the land owned by LandCo is rented to Able's farming activity and he materially participates in that farming activity. The cash-rent income is self-rental income and is considered **nonpassive** income for purposes of both income tax and the NIIT. In addition, any resulting gain from the sale of assets is nonpassive.

Example 7. Amber's farming operation, Amberwaves Company, is a C corporation. Amberwaves cash rents farmland owned by an LLC that Amber also owns. The cash-rent income is self-rental income and is considered **nonpassive** income for purposes of both income tax and the NIIT. In addition, any resulting gain from the sale of assets is nonpassive.

Example 8. Bob's farming operation, Greenway, Inc., is an S corporation that cash rents farmland from an LLC that Bob also owns. The cash-rent income is considered nonpassive self-rental income. Bob could also make an election to group the LLC and Greenway, Inc., as a single material participation activity. As a result, all income or loss is not subject to any passive loss restrictions and is not subject to the NIIT. In addition, any resulting gain from the sale of assets is nonpassive.

For farmers who materially participate in a farming operation but have income from other activities in which they do not materially participate, a grouping election can be made so that all of the activities are treated as a single activity producing active business income not subject to the NIIT.[44]

44. Treas. Reg. §1.469-4(c).

Example 9. George's corn 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 by the S corporation's activities 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. The income that the ethanol plant generates is passive to George; thus, the NIIT would potentially apply to George's income from his investment in the ethanol plant. However, George can make a grouping election if he satisfies the conditions of Treas. Reg. §1.469-4(d)(1) to treat the two S corporations as a single activity. The election allows George to be deemed as materially participating in the activities of the ethanol plant by virtue of his participation in the farming activities. Consequently, George's income from the ethanol plant is not subject to the NIIT.

Regroupings. The final regulations[45] address when a taxpayer can revise a grouping election because of the NIIT. The proposed regulations indicate that a taxpayer can revise any grouping election in the first year that the taxpayer meets both of the following tests.

- Meets the income threshold requirements for the NIIT
- Has investment income

The final regulations retain these same regrouping provisions.[46] They also provide additional clarification regarding amended tax returns and examinations. If a taxpayer properly made a regrouping election and it was later determined that adjustments required an amended tax return that either reduced gross income below the threshold level or eliminated investment income, then the taxpayer is required to undo the regrouping election and is bound by this until both tests are satisfied in the future. Conversely, if a taxpayer had not made a regrouping election because their income was under the threshold level but additional income was determined after filing the original return, the taxpayer is allowed to make a regrouping election at that time. When an examination of a taxpayer's records results in a redetermination of income, then the taxpayer is subject to the same provisions.

Example 10. Guy Wire is a single taxpayer with 2013 Schedule F income of $175,000 and interest income of $20,000. His total income of $195,000 is under the threshold level for the NIIT. Thus, Guy is not allowed to make any regrouping elections in 2013. Later, it is determined that $10,000 of additional farm income was not reported on the original return. When the amended tax return is prepared, Guy can make a regrouping election at that time because his gross income now exceeds the threshold amount of $200,000. Guy is then bound by that election for subsequent years.

Observation. Grouping can cause suspended passive losses to be unavailable until all of the grouped activities are disposed of.[47]

45. TD 9644, 2013-51 IRB 676.

46. Treas. Reg. §1.469-11(b)(3)(iv).

47. IRC §469(g)(1)(A).

Relief for Self-Charged Interest Income

Treas. Reg. §1.469-7 provides that in the case of self-charged items of interest income received from a nonpassive entity, the amount of interest income excluded from NII is the taxpayer's allocable share of the nonpassive deduction.

Example 11. Evan Keel owns 90% of Farmco, Inc., an S corporation in which he materially participates. During the year, Evan loaned Farmco $300,000 and received $20,000 of interest income. Consequently, $18,000 ($20,000 × 90%) of the interest that Evan receives is excluded from investment income. He only reports $2,000 of interest income as investment income.

Note. If the self-charged interest was deducted in arriving at self-employment (SE) income at the entity level, then all of the self-charged interest is treated as investment income. That is a relevant consideration when the entity involved is an LLC. Interest paid by an LLC reduces the SE income of the LLC.

Offsetting Other Investment Income with Net Losses

Under proposed regulations, losses from the sale of assets could only be used to offset gains from the sale of assets. For NIIT purposes, if a net loss resulted after netting gains and losses, the loss could not be used. Although the final regulations essentially retained the same language as the original proposed regulations regarding limiting net losses to zero, Treas. Reg. §1.1411-4(d)(2) was added, which allows a net capital loss deduction of $3,000 to offset other investment income.

Note. For individuals, when capital losses exceed capital gains, up to $3,000 ($1,500 for MFS taxpayers) can be used to reduce other types of income. Any amount of net capital losses in excess of $3,000 is carried forward to future years.

The final regulations include Treas. Reg. §1.1411-4(f)(4), which states that any losses in excess of gains may now be used to offset other types of NII, but only to the extent that the losses are used to currently reduce the taxpayer's taxable income. This does not mean that a net loss can be created. However, any losses that exceed net gains and are currently allowable in determining taxable income can be used to reduce other items of NII.

Example 12. In 2014, Sara sells IBM stock for a $15,000 loss. The stock also generated $5,000 of dividend income during the year. She has no other gains or losses or investment income for the year. Thus, Sara can deduct $3,000 of the capital losses against other investment income for the 2014 tax year. Sara's NII is $2,000 ($5,000 of dividend income − $3,000 capital loss allowed).

Example 13. Ron invested in an ethanol plant that usually generates $100,000 of passive income every year. However, in 2013, in addition to the $100,000 of passive ordinary income, the ethanol plant sold some assets for a net IRC §1231 loss of $100,000. For income tax purposes, Ron can offset the $100,000 of §1231 losses against his $100,000 of passive income, for net taxable income of zero. The loss is fully allowed, which results in NIIT of zero.

A net operating loss (NOL) can partially offset investment income. Because NOLs are computed and carried over each year, a separate ratio must be determined for each year. The portion of an NOL that is deductible against investment income (the IRC §1411 NOL) is calculated by first determining the applicable portion of the NOL for each loss year.

Note. Essentially, the taxpayer must determine two NOLs for any loss year. First, the regular NOL computed under IRC §172 is determined. Second, the §1411 NOL that arises only from NII sources is determined. This NOL is then divided into the regular NOL to arrive at a factor for that loss year.

Sale of Farmland and the NIIT

Capital gain income can trigger the application of the NIIT. However, if the capital gain is attributable to the sale of a capital asset that is used in a trade or business in which the taxpayer materially participates, the NIIT does not apply. For purposes of the NIIT, **material participation** is determined in accordance with the passive loss rules of IRC §469.

> **Note.** For more information about the passive loss rules, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Passive Activities.

If an active farmer sells a tract of land from their farming operation, the capital gain recognized on the sale is not subject to the NIIT. However, whether the NIIT applies to the sale of farmland by a retired farmer or a surviving spouse is not so easy to determine. There are two approaches to determining whether the NIIT applies to such sales.

1. The IRC §469(h)(3) approach
2. The IRC §469 approach

IRC §469(h)(3) Approach. IRC §469(h)(3) provides that "a taxpayer shall be treated as materially participating in any farming activity for a taxable year if paragraph (4) or (5) of IRC §2032A(b) would cause the requirements of IRC §2032A(b)(1)(C)(ii) to be met with respect to real property used in such activity if such taxpayer had died during the taxable year." The requirements of §2032A(b)(1)(C)(ii) are met if the decedent or a member of the decedent's family materially participated in the farming activity five or more years during the eight years preceding the decedent's death. In applying the 5-out-of-8-year rule, the taxpayer may disregard periods in which the decedent was retired or disabled.[48] If the 5-out-of-8-year rule is met with regard to a deceased taxpayer, it is deemed to be met with regard to the taxpayer's surviving spouse, provided that the surviving spouse actively manages the farming activity when the spouse is not retired or disabled.[49]

A retired farmer is considered to be materially participating in a farming activity if the retired farmer is:

- Continually receiving social security benefits or is disabled, and
- Materially participated in the farming activity for at least five of the last eight years immediately preceding the earlier of death, disability, or retirement (defined as receipt of social security benefits).

The 5-out-of-8-year test, once satisfied by a farmer, is deemed to be satisfied by the farmer's surviving spouse if the surviving spouse is receiving social security. Until the time at which the surviving spouse begins to receive social security benefits, the surviving spouse must actively participate in the farming operation to meet the material participation test.

"Normal" IRC §469 Approach. IRC §469(h)(3) concerns the recharacterization of a farming activity, but not the recharacterization of a rental activity. Thus, if a retired farmer is no longer farming but is engaged in a rental activity, §469(h)(3) does not apply, and the normal material participation tests under §469 apply. The only one of those tests that is likely to have any potential application in the context of a retired farmer is whether the taxpayer materially participated in the farming activity for at least five of the previous 10 years immediately preceding the sale. This approach would cause more transactions to be subject to NIIT than the IRC §469(h)(3) approach.

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48. IRC §2032A(b)(4).

49. IRC §2032A(b)(5).

Sale of Land Held in Trust. When farmland that was held in trust is sold, the IRS position is that only the trustee of the trust can satisfy the material participation tests of §469. This position was rejected by the one federal district court that has ruled on the issue,[50] but the IRS, while not appealing the court's opinion, has continued to assert its judicially rejected position.

In early 2014, the U.S. Tax Court rejected the IRS's position.[51] The Tax Court held that the conduct of the trustees acting in the capacity of trustees counts toward the material participation test as well as the conduct of the trustees as employees. The Tax Court did not rule out meeting the material participation test through the participation of nontrustee employees, but because the facts showed trustee participation, it declined to address the issue.

Trading in Commodities and the NIIT

The NIIT applies to a trade or business of trading in financial instruments or trading in commodities.[52] The definition of **commodities** for purposes of the NIIT[53] includes the following.

- Actively traded personal property[54]
- Any option, forward contract, futures contract, short position, or any similar instrument in a covered commodity[55]
- A hedge with respect to such commodity

To be subject to the NIIT, **the taxpayer must be engaged in the trade or business of trading in commodities.** For taxpayers that are owners of pass-through entities, that determination is made at the entity level.[56] For taxpayers that are directly engaged in a trade or business, the determination of whether the taxpayer is engaged in the trade or business of trading in commodities is determined at the owner level. Thus, a sole proprietor farmer's income from hedging activity or the hedging income of a farming entity structured as a pass-through entity **is not subject to the NIIT.** This is because the farmer or entity is engaged in the trade or business of farming and not the trade or business of trading in commodities.

Hedging gains for a farmer are, therefore, not subject to the NIIT. However, if the farmer's commodity trading activity does not satisfy the definition of hedging, the resulting income or loss is speculative in nature.

Note. Speculative income from trading in commodities is subject to the NIIT under IRC §1411(c)(1)(A)(iii). That Code section says that the NIIT applies to net gains attributable to the disposition of property other than property held in a trade or business in which the taxpayer materially participates. The speculative gains and losses are subject to the standard 60% long-term capital gain (or loss) and 40% short-term capital gain (or loss)[57] treatment. The additional 3.8% NIIT also applies.

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50. *Mattie Carter Trust v. U.S.*, 256 F.Supp.2d 536 (N.D. Tex. 2003).
51. *Frank Aragona Trust v. Comm'r,* 142 TC 9 (Mar. 27, 2014).
52. Treas. Reg. §1.1411-5(a)(2).
53. IRC §475(e)(2).
54. See IRC §1092(d)(1).
55. IRC §475(e)(2)(C).
56. Treas. Reg. §1.1411-4(b)(2)(ii).
57. IRC §1256.

ENTITY PLANNING ISSUES AND THE ADDITIONAL TAXES UNDER THE ACA

In addition to the tax of 3.8% on certain passive income (the NIIT), the ACA also increased the Medicare tax rate from 2.9% to 3.8% for certain taxpayers. This additional 0.9% tax is often referred to as the **additional Medicare tax.** The additional Medicare tax is imposed on taxpayers with wages and/or SE income above the same threshold amount that applies for purposes of the NIIT.

From an estate planning, business planning, and succession planning perspective, the NIIT and the additional Medicare tax have implications for trusts and may encourage many entities to adopt the pass-through tax treatment provided by partnerships, LLCs, and S corporations.

> **Note.** For more information about the additional Medicare tax, see the 2014 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Affordable Care Act Update.

Trusts

Under proposed regulations, the NIIT threshold for trusts is the dollar amount at which the highest tax rate bracket for trusts begins ($11,950 for 2013 and $12,150 for 2014). The NIIT applies to the lesser of undistributed NII or the excess of the trust's AGI over the threshold. The regulations allocate investment income between distributed and undistributed income under the usual trust allocation rules. Electing small business trusts (ESBT) must combine their S corporation and non-S corporation income for purposes of computing the tax.[58] For charitable remainder trusts, the proposed regulations treat part of the distributions as investment income.[59]

> **Note.** For more information about the application of the NIIT to trusts, see the 2014 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Affordable Care Act Update.

> **Note.** Foreign estates and trusts are not normally subject to the NIIT. The proposed regulations state that the IRS will subject U.S. beneficiaries to the NIIT on their share of distributed investment income.

Pass-Through Entities

Although pass-through entities are not subject to the additional Medicare tax, direct or indirect owners (individuals, trusts, and estates) may be subject to taxation on the allocable portion of income and gain derived from these entities. Taxpayers must take into account the additional Medicare tax in determining their estimated tax payments.[60]

Partnerships

Although the NIIT does not apply to income from a trade or business conducted by a partnership (other than passive income), the income, gain, or loss on working capital is not considered derived from a trade or business and is subject to the NIIT.[61] Gain or loss from a disposition of a partnership interest is included in a partner's NII only to the extent of the net gain or loss the partner would take into account if the partnership sold all its property for fair market value (FMV) immediately before the disposition of the partnership interest.[62] This means that if a taxpayer materially participates in a partnership with trade or business income, the taxpayer will have SE income that is potentially subject to the additional Medicare tax of 0.9% and the standard Medicare tax of 2.9%. If the taxpayer does not materially participate in the partnership, the taxpayer's share of partnership income may be subject to the NIIT.

58. Prop. Treas. Reg. §1.1411-3(c)(1)(ii).

59. Prop. Treas. Reg. §1.1411-3(c)(2).

60. IRC §6654.

61. IRC §1411(c)(3).

62. IRC §1411(c)(4).

S Corporations

S corporation income reported on Schedule K-1, *Shareholder's Share of Income, Deductions, Credits, etc.,* is not subject to SE tax. In addition, the NIIT does not apply to business income earned by active S corporation shareholders, even if their income is over the threshold amounts. **The NIIT does apply, however, to the income of passive shareholders in an S corporation.**

> **Observation.** Generally, an S corporation is favored over a partnership because active S corporation shareholders can avoid both the SE tax and the NIIT. For more information about the factors that should be considered when selecting the form of a business operation, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: Entity Selection.

Limited Liability Companies

In general, income that is subject to SE tax is not subject to the NIIT. For an LLC, business income allocated to the general partners of an LLC taxed as a partnership is generally subject to SE tax even if it flows to a partner who does not participate in the operations of the LLC.[63] There is no guidance on the SE tax treatment of income flowing to LLC owners (and limited liability partnership (LLP) owners) who do not participate in the operations of the business. However, to the extent a limited liability owner (either an LLC member or an LLP partner) receives a guaranteed payment for services, the law is clear that this payment is subject to SE tax.[64] Thus, guaranteed payments for services or capital would always appear to be subject to SE tax, even if paid to an individual holding a limited liability interest.[65] Proposed regulations hold that a limited liability partner is subject to SE tax under any one of three circumstances.[66]

1. The individual has personal liability for the debts of, or claims against, the partnership by reason of being a partner or member.
2. The individual has authority under the statutes of the state in which the partnership is formed to contract on behalf of the partnership (i.e., the individual has management authority).
3. The individual participated in the entity's trade or business for more than 500 hours during the entity's taxable year.

Manager-Managed LLC. An LLC may be member-managed or manager-managed. The owners of the LLC are responsible for managing the company in a member-managed LLC. A manager-managed LLC is operated by managers who are appointed to run the company. Manager-managed LLCs operate in a similar fashion to a corporation that has a board of directors to control the company's affairs. LLC members that adopt a manager-managed structure may prefer to take a more passive role in terms of operating the company. By hiring third-party managers, the members of the company can concentrate on building the business, as opposed to addressing the needs of the LLC on a daily basis.

A manager-managed LLC may provide separate classes of membership for managers (who have the authority to bind the LLC under a contract) and nonmanagers (who have no such authority). The use of a manager-managed LLC with two classes of membership provides SE tax savings to the nonmanaging members.

> **Note.** Both classes provide limited liability protection to the members in their capacity as members.

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63. Treas. Reg. §1.1402(a)-2(g).
64. IRC §1402(a)(13); and Prop. Treas. Reg. §1.1402(a)-2(g).
65. Treas. Reg. §1.1402(a)-(1)(b).
66. Prop. Treas. Reg. §1.1402(a)-2(h)(2).

Nonmanagers who do not meet the 500-hour participation test are only subject to SE tax to the extent of any guaranteed payments they receive. Nonmanagers who exceed the 500-hour test are not subject to SE tax if they own a substantial continuing interest (i.e., at least 20%) in a particular class of interest and the individual's rights and obligations of that class are identical to those held by persons who satisfy the general definition of limited partner (i.e., fewer than 500 hours for a nonmanager).

Note. Managers are subject to SE tax on income from that substantial continuing interest. If there are nonmanagers who spend fewer than 500 hours with the LLC **and** such members own at least 20% of the interests in the LLC, the nonmanagers in that LLC who spend more than 500 hours **are not subject to SE tax** on the pass-through income but are subject to SE tax on the guaranteed payments.[70]

It is possible to structure a manager-managed LLC with the taxpayer holding both manager and nonmanager interests. In this type of structure, individuals with nonmanager interests who work fewer than 500 hours with the LLC must own at least 20% of the LLC interests.

Note. This exception allows the individual who holds both manager and nonmanager interests to be exempt from SE tax on the nonmanager interest.[71] The taxpayer is subject to SE tax on the pass-through income and guaranteed payments of the manager interest.

Structuring the Manager-Managed LLC. In an LLC that is structured to minimize SE tax and avoid the NIIT, all of the LLC interests can be owned by nonmanagers (investors) with a third party nonowner named as manager and some or all of the investors working on behalf of the manager. The manager could be an S corporation or a C corporation, with the LLC investors owning part or all of the corporation. The manager must be paid a reasonable management fee and the LLC owners who provide services to the LLC must be paid reasonable compensation. The LLC owners who do not render services to the LLC do not have income that is subject to SE tax. The manager earns a 1% manager interest for the services rendered to the LLC, which generates a guaranteed payment. The guaranteed payment is subject to SE tax.

In summary, LLC nonmanagers working fewer than 500 hours annually are subject to SE tax only on guaranteed payments. Nonmanagers who work more than 500 hours annually are subject to SE tax only on guaranteed payments if the nonmanagers who work fewer than 500 hours annually make up at least 20% of the membership. Although the managers and nonmanagers own interests commensurate with their investment (i.e., nonmanager interests), the managers also receive manager interests as a reward for their services. Managers recognize SE income on the pass-through income associated with the manager interests. With the exception of guaranteed payments, nonmanager interests are not subject to SE tax.

For the NIIT, a nonmanager's interest in a manager-managed LLC is normally considered passive and is subject to the NIIT.[69] However, a spouse may take into account the material participation of their spouse who is the manager.[70] Thus, if the manager spouse materially participates, then **all** nonmanager interests owned by both spouses avoid the NIIT. The end result is that a manager-managed LLC can produce a better NIIT result than use of an S corporation.

Other Situations

Other farming arrangements may give rise to the possibility of farm income being subjected to the NIIT. These arrangements include hiring a farm manager and using multiple entities.

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67. Prop. Treas. Reg. §1.1402(a)-2(h)(4).
68. Prop. Treas. Reg. §1.1402(a)-2(h)(3).
69. IRC §1411(c)(2)(A).
70. IRC §469(h)(5).

Hired Farm Manager. It is common for farm owners to utilize farm management companies to perform all the day-to-day management of the farm. The share of farm income that the owner receives is potentially subject to the NIIT as passive income. The activity of the agent (farm management company) is not imputed to the principal (farm owner) for NIIT material participation purposes.

Multiple Entities. Farmers sometimes structure their farming businesses in multiple entities for estate and business planning purposes. For instance, a farmer may own an operational entity that contains the business operational assets and rent land to it that is owned by a different entity (or is owned individually). For land that is owned jointly by a married couple (either as joint tenants or as tenants in common), when the farming spouse pays the nonfarming spouse rent to reflect the nonfarming spouse's one-half interest, a question arises as to whether the NIIT applies to the rental income. The rental of property to the farming spouse's business in which the farmer materially participates is a self-rental that is not subject to the NIIT. Because the spouses are considered a unit for the regular passive loss rules, the rental income is **not passive income in the hands of the nonfarming spouse.**

DOMESTIC PRODUCTION ACTIVITIES DEDUCTION[74]

The domestic production activities deduction (DPAD) was enacted on October 22, 2004, as part of the American Jobs Creation Act of 2004. It became effective January 1, 2005, and is codified at IRC §199. IRC §199 contains many terms that may be unfamiliar to tax preparers. The following acronyms are used throughout this section.

- QPAI: qualified production activities income
- DPGR: domestic production gross receipts
- CGS: cost of goods sold
- QPP: qualifying production property
- MPGE: manufactured, produced, grown, or extracted

CALCULATING AND CLAIMING THE DPAD

Except for domestic oil-related production activities,[72] for tax years beginning after 2009, the DPAD is equal to the lesser of:

- 9% of the taxpayer's QPAI for the year,
- 9% of the taxpayer's taxable income (for an individual, this limitation is applied to AGI), or
- 50% of the taxpayer's Form W-2 wages for the taxable year.[73]

Note. Taxpayers with current year NOLs or with NOL carryovers that eliminate current year taxable income cannot take the DPAD because of the taxable income limitation.[74]

71. This section is adapted from material from the Iowa Bar Association Tax Manual, which is continually updated.

72. For domestic oil-related production activities, IRC §199(d)(9) limits the deduction to 6%. For purposes of this provision, the term "oil-related production activities income" is the qualified production activities income of the taxpayer that is attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any of their primary products.

73. IRC §§199(a)(1) and (b)(1).

74. See IRC §§63 and 172.

The DPAD is allowed for **both** regular tax and alternative minimum tax (AMT) purposes (including adjusted current earnings). However, the DPAD is **not** allowed in computing SE income.[75]

The DPAD is available to pass-through entities such as S corporations, partnerships, and estates or trusts, but the deduction is applied at the shareholder, partner, or beneficiary level.[76] S corporations and partnerships with qualified activities are required to separately pass through the share of QPAI to each owner, reporting to each owner the corresponding Form W-2 wage amount and any additional detail that is needed to allow computation of the overall deduction at the Form 1040 level. The DPAD for pass-through entities is discussed in more detail later in this chapter.

Agricultural cooperatives may also claim the DPAD. However, the amount of any patronage dividend or per-unit retain allocations to a member of the cooperative that are allocable to qualified production activities are deductible from the gross income of the member. Further discussion is provided later.

Form 8903, *Domestic Production Activities Deduction,* is used to calculate the DPAD. Individuals claim the amount calculated on Form 8903 as an adjustment to income on line 35 of Form 1040, which includes their share of the DPAD from pass-through entities. C corporations claim the amount calculated on Form 8903 on line 25 of Form 1120, *U.S. Corporation Income Tax Return.*

Estates and trusts are eligible for the DPAD if the income is not passed through to the beneficiaries. Most service activities do not qualify for the deduction.[77]

Whether a farm landlord is eligible depends on whether the rents are from real property (in which event they are not taken into account for purposes of the DPAD) or from the conduct of a trade or business. As a practical matter, however, few farm landlords can claim the deduction due to the W-2 wage limitation.

Note. It is the MPGE portion of tangible personal property that gives rise to the deduction, not real property. For example, in CCA 201302017, the IRS stated that mobile billboards constitute tangible personal property that qualifies for the deduction, but traditional and modern billboards are real property (an inherently permanent structure) that does not qualify for the deduction.

Qualified Production Activities Income

QPAI equals the taxpayer's DPGR reduced by the sum of:

1. CGS,
2. Other expenses directly allocable to DPGR, and
3. A ratable portion of other expenses and losses not directly allocable to DPGR.[78]

When gross receipts and expenses are recognized in different taxable years, taxpayers must take receipts and expenses into account for purposes of the DPAD in the tax year the items are recognized under the taxpayer's method of accounting for federal income tax purposes.[79] However, if the taxpayer is engaged exclusively in the production of qualified property in the United States and has no other sources of income, QPAI is likely to equal overall taxable income (AGI for individuals).

75. IRC §199(d)(6).

76. IRC §199(d)(1)(A).

77. See, e.g., CCM 20133302F (Jul. 16, 2013). (A pharmacy that processed photos at retail stores could claim the DPAD for photo processing services because photos are created from raw materials. However, affixing resulting processed photo or movie files onto photo CDs and movie DVDs is not a qualified service activity because the files are intangible products and the CDs or DVDs were not changed in form.)

78. IRC §199(c)(1).

79. Treas. Reg. §1.199-1(e).

Domestic Production Gross Receipts

QPAI is derived from DPGR, which includes gross receipts resulting from the following.[80]

- Any lease, rental, license, sale, exchange, or other disposition of qualifying production property (QPP) that was manufactured, **produced, grown,** or extracted by the taxpayer in whole or significant part within the United States
- Any qualified film produced by the taxpayer
- Electricity, natural gas, or potable water produced by the taxpayer in the United States
- Construction performed in the United States
- Engineering or architectural services performed in the United States (for construction projects in the United States)

The statute states that "this section shall be applied by only taking into account items which are attributable to the actual conduct of a trade or business."[81] Unfortunately, the final regulations provide no clarification as to what level of activity constitutes a "trade or business." This is a major issue for taxpayers who are not materially participating landlords. However, the Tax Court has noted that a factor in determining the availability of the DPAD in a contractual situation is whether the taxpayer "actively and extensively" participated in the management and operations of the activity.[82] In addition, there must be gross receipts or QPAI from the activity in order for the taxpayer to claim the DPAD.[83] A taxpayer's method for determining DPGR and non-DPGR must be a reasonable method that accurately identifies the gross receipts derived from activities described in IRC §199(c)(4) based on all the information available to the taxpayer to substantiate the deduction.

Note. For purposes of complying with the MPGE requirement, packaging, repackaging, labeling, or minor assembly activities alone[84] (i.e., with no other MPGE activities performed on the item) do not qualify as MPGE activities within the meaning of Treas. Reg. §1.199-3(a)(1). However, when additional qualifying MPGE activities occur with respect to the same qualified property, the exception does not apply and the DPAD is available.[85]

Qualifying Production Property. QPP includes the following types of property.[86]

- Tangible personal property
- Any computer software
- Sound recordings as defined in IRC §168(f)(4)

80. IRC §199(c)(4)(A).

81. IRC §199(d)(5).

82. *Advo, Inc. & Subsidiaries v. Comm'r,* 141 TC 9 (2013).

83. *Longino v. Comm'r,* TC Memo 2013-80 (Mar. 18, 2013). (No DPAD was available for grading or surveying expenses on property claimed to be held for timber harvesting, because no timber was harvested; hence, the property did not generate any gross receipts or QPAI.)

84. Treas. Reg. §1.199-3(e)(2).

85. CCA 201246030 (Aug. 9, 2012).

86. IRC §199(c)(5).

QPP must be "manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States."[87] One of the following two tests must be satisfied to determine whether QPP meets this requirement.

1. The **substantial-in-nature** test is satisfied if the MPGE activity performed by the taxpayer is substantial in nature based on all the taxpayer's facts and circumstances.[88]
2. The **cost safe harbor** test is satisfied if the conversion costs (direct labor and factory burden) incurred by the taxpayer in the United States for the MPGE portion of the QPP are at least 20% of the taxpayer's total cost for the property.[89]

When multiple corporations are involved in developing and commercializing a product, this collaboration may constitute a partnership based on the facts of the situation. If the product is produced in significant part in the United States, the DPAD is allowable and is allocated to the partners.[90]

DPGR for Agricultural Operations. DPGR includes the gross receipts from growing and producing tangible property such as grain and livestock. Other activities in the agricultural context include the following.

- **Support/service activities.** Gross receipts from seed or chemical sale endeavors do **not** qualify as DPGR because these activities do not involve manufacturing or growing. Similarly, gross receipts from services provided to other producers (e.g., trucking, combining, spraying, plowing, etc.) also do **not** qualify.
- **Crop insurance/FSA subsidies.** The proceeds from business interruption insurance, governmental subsidies, and governmental payments not to produce are treated as gross receipts that qualify for the DPAD. Accordingly, crop insurance and FSA subsidies **qualify** as production receipts.[91]
- **Sales of productive livestock.** The sale of raised livestock, as well as purchased livestock held for resale, qualifies for the DPAD based on the "growing" category of DPGR.
  - **Raised livestock.** The regulations are silent about whether raised livestock that is placed into a breeding herd, and subsequently culled in later years after productive use as a breeding or dairy animal, qualifies as DPGR. However, because the definition of DPGR includes the sale of personal property grown by the taxpayer and there is no distinction in the DPGR rules requiring that the asset be held as inventory rather than held for productive use, it would appear that proceeds from raised breeding and dairy stock **qualify** as DPGR.
  - **Purchased breeding and dairy livestock.** Purchased breeding and dairy stock that was acquired as a mature animal and is held by the taxpayer for productive use, depreciated, and subsequently sold may not meet the "manufactured, produced, grown, or extracted" (MPGE) requirement. Additionally, it is clear that only one taxpayer can claim the DPAD for an item of tangible property.[92] Based on these facts, it would appear that purchased breeding and dairy animals that are subsequently sold **do not count** as qualifying DPGR.

Note. The taxpayer must bear the **benefits and burdens** of ownership and be the exclusive owner of the underlying property such that the taxpayer is the only one who could claim the DPAD.[93] Several factors are important in making this determination, including whether legal title has passed, how the parties treat the transaction, whether rights of possession are vested in the buyer, which party controls the production process, and whether the taxpayer actively and extensively participated in the management and operations of the activity.[94]

87. IRC §199(c)(4)(A)(i)(I).
88. Treas. Reg. §1.199-3(g)(2).
89. Treas. Reg. §1.199-3(g)(3).
90. CCA 201323015 (Feb. 21, 2013).
91. Treas. Reg. §1.199-3(i)(1)(iii).
92. Treas. Reg. §1.199-3(f)(1).
93. Ibid.
94. See, e.g., *Advo, Inc. & Subsidiaries v. Comm'r,* 141 TC 9 (2013).

> **Note.** The IRS provides guidance to auditors who need to determine which party qualifies for the DPAD when one party contracts manufacturing out to another party. According to the guidance, auditors can request that the taxpayer provide a certification statement on the issue of the benefits and burdens of ownership. Once certification is received, the IRS will not challenge the taxpayer on the benefits/burdens issue.[95]

- **Hedging transactions.** Gains or losses from hedges **qualify** as DPGR if the hedge involves the purchase of supplies used in the taxpayer's business, the sales of stock in the taxpayer's trade or other property of a kind that would be included in inventory if it is on hand at the close of the taxable year, or property held for sale to customers in the ordinary course of the trade or business. If the hedge involves the purchase of stock in trade, inventory property, or property held for sale, gains and losses are taken into account in determining the CGS.[96]
- **Storage.** Storage, handling, or other processing activities (other than transportation activities) within the United States related to the sale, exchange, or other disposition of agricultural products **qualify** as DPGR, provided the products are consumed in connection with, or incorporated into, the MPGE portion of QPP, regardless of whether this is done by the taxpayer.

Example 14. Abe, Bob, Chuck, and Don are unrelated. Bob grows his wheat in Kansas. Abe owns grain storage bins in Kansas; Abe stores Bob's wheat in the bins and charges a storage fee. Bob sells his wheat to Chuck, a processor of wheat who processes Bob's wheat into flour in Kansas. Chuck stores flour in Don's warehouse until it is sold to a local bakery.

The gross receipts from Bob's wheat farming activity, Abe's storage activity, and Chuck's processing activity are DPGR. Don's income from the flour's storage in his warehouse is not DPGR. Don's activity does not involve the rental of a grain production facility.

Example 15. Tex places his hogs in the Swine Place feedlot. The fees Swine Place collects on Tex's pigs are not DPGR. Only income attributable to pigs owned by Swine Place generates DPGR. To constitute DPGR, the taxpayer must bear the benefits and burdens of ownership of the QPP during the period of the MPGE activity in order for the applicable gross receipts to qualify as DPGR.

Mineral Interests. Gross receipts from **operating** mineral interests count as DPGR. However, gross receipts from mineral royalties and net profits interests (other than those derived from operating mineral interests) are treated as returns on passive interests in mineral properties. Because the owner makes no expenditure for operation or development, royalties and net profits interests are **not** treated as DPGR.[97]

De Minimis Rule. A safe harbor or de minimis rule is provided that allows the taxpayer with less than 5% of total gross receipts from non-DPGR items to treat all gross receipts as DPGR.[98] However, if the amount of the taxpayer's gross receipts that do **not** qualify as DPGR equals or exceeds 5% of the total gross receipts, the taxpayer **must** allocate all gross receipts between DPGR and non-DPGR. In the case of a pass-through entity, the determination of whether the 5% test is satisfied is made at the entity level.[99] For owners of pass-through entities, the determination of whether less than 5% of the owner's total gross receipts are non-DPGR is made at the owner level, taking into account all of the owner's gross receipts from all trade or business activities.[100]

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95. *Guidance for Examiners on IRC §199 Benefits and Burdens of Ownership Analysis in Contract Manufacturing Arrangements.* Jul. 24, 2013. [www.irs.gov/Businesses/Guidance-for-Examiners-on-IRC-199-Benefits-and-Burdens-of-Ownership-Analysis-in-Contract-Manufacturing-Arrangements] Accessed on Jul. 16, 2014.

96. Treas. Reg. §1.199-3(i)(3).

97. Treas. Reg. §1.199-3(h)(9).

98. Treas. Reg. §1.199-1(d)(3)(i).

99. Treas. Reg. §1.199-1(d)(3).

100. Ibid.

Example 16. John is a sole proprietor farmer who paid $20,000 in W-2 wages in 2013. He reports the following income and expense on his 2013 Schedule F and Form 4797, *Sales of Business Property.*

	Schedule F	Form 4797 (§1231 Machinery Sale)	Total
Gross receipts	$500,000	$20,000	$520,000
Expenses/basis	(440,000)	(10,000)	(450,000)
Net	$ 60,000	$10,000	$ 70,000

John qualifies under the 5% de minimis test. His non-DPGR from dispositions of equipment is $20,000, which is less than 5% of his total business gross receipts (5% × $520,000 = $26,000). Accordingly, John is entitled to claim the entire business net income of $70,000 as QPAI and claim a DPAD of $6,300 (9% × $70,000).

Gross receipts for purposes of calculating the DPGR are **not** reduced by CGS, including the cost of depreciable property held for productive use.[101] Thus, gross receipts from the sale of equipment, vehicles, livestock, and other §1231 productive property are **not reduced by the adjusted basis of the property** for purposes of determining whether the taxpayer meets the 5% de minimis test.

Note. If the gross amount of Form 4797 sales that are **not** QPAI (e.g., machinery sales) exceeds 5% of total gross receipts, the taxpayer must segregate those gross receipts in calculating QPAI.

Allocating Deductions between DPGR and Non-DPGR. If a taxpayer does not qualify under the 5% de minimis test because they have over 5% of gross receipts from nonqualifying activities, it is necessary to allocate deductions to arrive at QPAI attributable to DPGR. The regulations provide three methods for allocating deductions apportioned to DPGR.[102]

1. **Section 861 method.** This is the general method available to all taxpayers. Business deductions are allocated and apportioned to DPGR on a line-by-line basis by applying the cost allocation and apportionment rules of the regulations under IRC §861.

2. **Simplified deduction method.** Any taxpayer with **average annual gross receipts** of $100 million or less **or total assets** at the end of the year of $10 million or less may use the simplified deduction method. Under this method, a taxpayer's deductions are generally **apportioned ratably** between DPGR and non-DPGR based on relative gross receipts. However, **cost of goods sold must track specifically** to DPGR or non-DPGR.

Note. Average annual gross receipts is based on the three taxable years preceding the current taxable year.[103]

3. **Small business simplified overall method.** A qualifying small taxpayer with average annual gross receipts of $5 million or less or a taxpayer with under $10 million of gross receipts who is eligible to use the cash method under Rev. Proc. 2002-28 may use DPGR and non-DPGR to **apportion all deductions, including CGS,** based on relative gross receipts. Eligible taxpayers include those engaged in farming who are not required to use the accrual method of accounting.

Note. For tax years beginning on or after June 1, 2006, the final regulations require that only gross receipts attributable to a business (excluding wages) may be considered for simplified allocation purposes.[104]

101. Treas. Reg. §1.199-3(c).
102. Treas. Reg. §§1.199-4(d), (e), and (f).
103. Treas. Reg. §1.199-4(g).
104. Treas. Reg. §1.199-8(c)(2).

Example 17. Use the same facts as **Example 16,** except John reports higher farm equipment sales on Form 4797.

	Schedule F	Form 4797 (§1231 Machinery Sale)	Total
Gross receipts	$500,000	$50,000	$550,000
Expenses/basis	(440,000)	(10,000)	(450,000)
Net	$ 60,000	$40,000	$100,000

John fails the 5% de minimis test because his nonqualifying receipts ($50,000 of equipment sales) exceed $27,500 (5% × $550,000 total business gross receipts). Thus, John's equipment sales are non-DPGR, and he must allocate expenses to his $500,000 of qualifying DPGR. As a cash-method farmer, John is entitled to use the small business simplified overall method to allocate expenses based on his ratio of DPGR ($500,000) to total gross receipts ($550,000), which is 90.9%. John uses the amounts in the following table to complete Form 8903.

Line 1: DPGR	$500,000
Line 4: Expenses ($450,000 × 90.9%)	(409,050)
Line 6: Net qualifying production income	$ 90,950
	× 9%
Line 13: DPAD	$ 8,186

John benefits from using the small business simplified overall method in determining expenses attributable to DPGR, because some of his farm expenses are effectively allocated to non-DPGR (machinery sale receipts). If John had used the §861 method, he would have reported the $60,000 Schedule F net income as his net QPAI and could only claim a DPAD of $5,400 (9% × $60,000).

John's Form 8903 follows.

For Example 17

Form **8903** (Rev. December 2010) Department of the Treasury Internal Revenue Service

Domestic Production Activities Deduction

▶ Attach to your tax return. ▶ See separate instructions.

OMB No. 1545-1984

Attachment Sequence No. 143

Name(s) as shown on return: John Farmer

Identifying number: 111-22-3333

Note. Do not complete column (a), unless you have oil-related production activities. Enter amounts for all activities in column (b), including oil-related production activities.

			(a) Oil-related production activities	(b) All activities
1	Domestic production gross receipts (DPGR)	1		500,000
2	Allocable cost of goods sold. If you are using the small business simplified overall method, skip lines 2 and 3	2		
3	Enter deductions and losses allocable to DPGR (see instructions)	3		
4	If you are using the small business simplified overall method, enter the amount of cost of goods sold and other deductions or losses you ratably apportion to DPGR. All others, skip line 4	4		409,050
5	Add lines 2 through 4	5		409,050
6	Subtract line 5 from line 1	6		90,950
7	Qualified production activities income from estates, trusts, and certain partnerships and S corporations (see instructions)	7		
8	Add lines 6 and 7. Estates and trusts, go to line 9, all others, skip line 9 and go to line 10	8		90,950
9	Amount allocated to beneficiaries of the estate or trust (see instructions)	9		
10a	**Oil-related qualified production activities income.** Estates and trusts, subtract line 9, column (a), from line 8, column (a), all others, enter amount from line 8, column (a). If zero or less, enter -0- here	10a		
b	**Qualified production activities income.** Estates and trusts, subtract line 9, column (b), from line 8, column (b), all others, enter amount from line 8, column (b). If zero or less, enter -0- here, skip lines 11 through 21, and enter -0- on line 22	10b		90,950

11	Income limitation (see instructions): • Individuals, estates, and trusts. Enter your adjusted gross income figured without the domestic production activities deduction • All others. Enter your taxable income figured without the domestic production activities deduction (tax-exempt organizations, see instructions)	11	100,000
12	Enter the smaller of line 10b or line 11. If zero or less, enter -0- here, skip lines 13 through 21, and enter -0- on line 22	12	90,950
13	Enter 9% of line 12	13	8,186
14a	Enter the smaller of line 10a or line 12 (14a)		
b	Reduction for oil-related qualified production activities income. Multiply line 14a by 3%	14b	
15	Subtract line 14b from line 13	15	8,186
16	Form W-2 wages (see instructions)	16	20,000
17	Form W-2 wages from estates, trusts, and certain partnerships and S corporations (see instructions)	17	
18	Add lines 16 and 17. Estates and trusts, go to line 19, all others, skip line 19 and go to line 20	18	20,000
19	Amount allocated to beneficiaries of the estate or trust (see instructions)	19	
20	Estates and trusts, subtract line 19 from line 18, all others, enter amount from line 18	20	
21	Form W-2 wage limitation. Enter 50% of line 20	21	10,000
22	Enter the smaller of line 15 or line 21.	22	8,186
23	Domestic production activities deduction from cooperatives. Enter deduction from Form 1099-PATR, box 6	23	
24	Expanded affiliated group allocation (see instructions)	24	
25	**Domestic production activities deduction.** Combine lines 22 through 24 and enter the result here and on Form 1040, line 35; Form 1120, line 25; or the applicable line of your return	25	8,186

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 37712F Form **8903** (Rev. 12-2010)

Observation. In general, taxpayers who dispose of machinery, equipment, or other business §1231 property reported on Form 4797 may find it possible to use those nonqualifying receipts in the §199 computation. Those business gross receipts may be under 5% and qualify for inclusion under the de minimis test (as explained earlier) or the taxpayer may benefit under one of the simplified allocation methods (as illustrated in the preceding example). The simplified allocation methods generally should be beneficial for equipment sales because businesses tend to dispose of fully depreciated items with little or no basis. Accordingly, when a simplified allocation method is used, business expenses that otherwise apply to DPGR are effectively shifted to the non-DPGR equipment sales.

Example 18. Bill's single-member LLC manufactures fertilizer products and also provides consulting services regarding best farming practices. In 2013, the LLC reported the following income and CGS.

	Manufacturing	Consulting	Total
Gross receipts	$160,000	$40,000	$200,000
CGS	(60,000)	(20,000)	(80,000)
Gross income	$100,000	$20,000	$120,000

Other expenses for the business totaled $50,000. Thus, 2013 net income for the business was $70,000 ($120,000 − $50,000). Bill's net QPAI is calculated as follows, using both the simplified deduction method and the small business simplified overall method.

Simplified Deduction Method

	Manufacturing	Consulting	Total
Gross income	$100,000	$20,000	$120,000
Other expenses	(40,000) [a]	(10,000) [b]	(50,000)
Net income	$ 60,000	$10,000	$ 70,000
DPAD rate	× 9%		
Tentative DPAD	$ 5,400		

[a] ($160,000 manufacturing gross ÷ $200,000 total gross) × $50,000 other expenses = $40,000

[b] ($40,000 consulting gross ÷ $200,000 total gross) × $50,000 other expenses = $10,000

Small Business Simplified Overall Method

	Manufacturing	Consulting	Total
Gross receipts	$160,000	$40,000	$200,000
CGS and other expenses	(104,000) [a]	(26,000) [b]	(130,000)
Net income	$ 56,000	$14,000	$ 70,000
DPAD rate	× 9%		
Tentative DPAD	$ 5,040		

[a] ($160,000 manufacturing gross ÷ $200,000 total gross) × $130,000 total expenses = $104,000

[b] ($40,000 consulting gross ÷ $200,000 total gross) × $130,000 total expenses = $26,000

As shown in the preceding calculation, Bill's tentative DPAD is higher using the simplified deduction method. If the amount calculated does not exceed half of the W-2 wages for the business, he can claim a DPAD of $5,400.

Note. The simplified deduction method computation in the preceding example resulted in a higher QPAI because CGS was a significant factor in both the DPGR and non-DPGR lines of business. If the consulting business had no CGS allocation or a relatively small CGS, the small business simplified overall method produces a higher QPAI result.

Example 19. Tom's single-member LLC manufactures fertilizer products and also provides consulting services regarding best farming practices. In 2013, the LLC reported the following income and cost of goods sold.

	Manufacturing	Consulting	Total
Gross receipts	$160,000	$40,000	$200,000
CGS	(80,000)	(0)	(80,000)
Gross income	$ 80,000	$40,000	$120,000

Other expenses for the business totaled $50,000. Thus, net income for the business for 2013 was $70,000 ($120,000 − $50,000). Tom's net QPAI is calculated as follows, using both the simplified deduction method and the small business simplified overall method.

Simplified Deduction Method

	Manufacturing	Consulting	Total
Gross income	$80,000	$40,000	$120,000
Other expenses	(40,000) [a]	(10,000) [b]	(50,000)
Net income	$40,000	$30,000	$ 70,000
DPAD rate	× 9%		
Tentative DPAD	$ 3,600		

[a] ($160,000 manufacturing gross ÷ $200,000 total gross) × $50,000 other expenses = $40,000
[b] ($40,000 consulting gross ÷ $200,000 total gross) × $50,000 other expenses = $10,000

Small Business Simplified Overall Method

	Manufacturing	Consulting	Total
Gross receipts	$160,000	$40,000	$200,000
CGS and other expenses	(104,000) [a]	(26,000) [b]	(130,000)
Net income	$ 56,000	$14,000	$ 70,000
DPAD rate	× 9%		
Tentative DPAD	$ 5,040		

[a] ($160,000 manufacturing gross ÷ $200,000 total gross) × $130,000 total expenses = $104,000
[b] ($40,000 consulting gross ÷ $200,000 total gross) × $130,000 total expenses = $26,000

As shown in the preceding calculation, Tom's tentative DPAD is higher using the small business simplified overall method. If the amount calculated does not exceed half of the W-2 wages for the business, he can claim a DPAD of $5,040.

W-2 Wage Limitation

The DPAD cannot exceed 50% of the Form W-2 FICA wages paid by the employer for the taxable year.[105] Thus, farm businesses that issue **no** Forms W-2 cannot claim the DPAD unless they receive DPAD as a pass-through from a cooperative.

Example 20. Mitch, a sole proprietor grain farmer, reports $70,000 of net income on his 2013 Schedule F. All of Mitch's Schedule F net income is attributable to qualifying production and growing activities. Thus, his DPAD could be as much as $6,300 (9% × $70,000). However, Mitch must have paid at least $12,600 in qualifying Form W-2 wages to claim the full $6,300 deduction ($12,600 × 50% = $6,300).

Form W-2 wages are the aggregate amount required to be included on Forms W-2, including all remuneration paid in any medium other than cash.[106] Noncash remuneration is excluded from wages if it is paid for agricultural labor unless the noncash remuneration is "wages" as defined in IRC §3121(a). Under §3121(a), "wages" means all remuneration for employment, including the cash value of all remuneration paid in any medium other than cash **except for in-kind wages paid for agricultural labor.**[107] Any services performed by a child under the age of 18 in the employ of their father or mother are also excluded from wages.[108]

Note. Form W-2 wages for purposes of the DPAD do **not** include any amount that is **not** properly included in a return filed with the Social Security Administration (SSA) on or before the 60th day after the due date (including extensions) for the return.[109] Additionally, wages paid to an employee for domestic services performed in the taxpayer's private home are **not** included in the taxpayer's W-2 wages.

Example 21. In 2013, Butch has $60,000 of Schedule F net income. He would be eligible for a DPAD up to $5,400 ($60,000 × 9%) if he had adequate wage payments from his farming operation. Monica, his wife, assisted significantly with farm planting and harvesting; thus, she could be paid a reasonable wage for her labor. Butch wants to know whether paying wages of $10,800 to Monica is worthwhile in order to obtain a DPAD. The social security and Medicare taxes paid on Monica's wages offset the SE tax on Butch's Schedule F net income.

The $10,800 wage reduces the Schedule F net income to $49,200 ($60,000 − $10,800). The DPAD on the net income is $4,428 ($49,200 × 9%), which is lower than half the amount of wages paid to Monica. The tax savings from the DPAD using a 15% tax rate is $664; at a 25% tax rate, the savings is $1,107. Additionally, state tax savings may also apply.

Using this strategy, Butch has lower social security earnings and Monica has higher social security earnings. This may or may not be a desired result.

Observation. For taxpayers with lower QPAI who are in lower marginal tax brackets, the process of preparing Forms W-2, W-3, *Transmittal of Wage and Tax Statements,* and 943, *Employer's Annual Federal Tax Return for Agricultural Employees,* (or Form 941, *Employer's Quarterly Federal Tax Return)* may not be worth the nominal savings. If net SE earnings exceed the maximum social security base amount ($113,700 for 2013 and $117,000 for 2014), incurring extra labor costs to qualify for the DPAD is generally not worth it.

105. IRC §199(b).
106. IRC §3401(a).
107. IRC §3121(a)(8)(A).
108. IRC §3121(b)(3)(A).
109. Treas. Reg. §1.199-2(a)(3).

Methods for Calculating W-2 Wages. Taxpayers must make some adjustments in order to determine wages for purposes of §199. As a result, the IRS provides three alternative methods for making the required calculations.

1. Under the **unmodified box method,** the taxpayer can treat wages as the **lesser of** the aggregate amount reported as "wages, tips and other compensation" (box 1) **or** "Medicare wages and tips" (box 5) on all Forms W-2 filed with the SSA for all employees during the year.
2. Under the **modified box 1 method,** the taxpayer can calculate wages by subtracting amounts that are **not** wages for withholding purposes and amounts that are merely treated as wages for withholding purposes from the totals reported in box 1. The result is then increased by employee salary reduction contributions to 401(k) arrangements and similar plans (reported in box 12 of Form W-2).
3. Under the **tracking wages method,** the taxpayer can track the actual amount of wages subject to federal income tax withholding, subtract supplemental unemployment compensation benefits that were included in that amount, and then add employee salary reduction contributions to 401(k) arrangements and similar plans (reported in box 12 of Form W-2). This method **must** be used if a short tax year is involved.

Note. The unmodified box method provides the simplest calculation. The modified box 1 and tracking wages methods provide greater accuracy.

PASS-THROUGH ENTITIES

The DPAD is available to trusts, estates, S corporations, partnerships, and other pass-through entities.[110]

Trusts and Estates

For grantor trusts, a person is treated as owning all or part of the trust and reports QPAI as if the income was generated by activities performed directly by the owner.[111] For a nongrantor trust or estate, all income and expense items are allocated to the beneficiaries based on the proportion of distributable net income deemed to be issued to that beneficiary for the taxable year.[112] Thus, a trust or estate may claim the DPAD to the extent that QPAI is allocated to the trust or estate, but the deduction applies at the beneficiary level.

Partnerships and S Corporations

In applying the deduction to pass-through entities, each owner is allowed to compute the deduction by taking into account their distributive or proportionate share of DPGR and allocable expenses. Partnerships are required to compute the partner's deduction separately, aggregating the partner's pro-rata share of the items allocated to the partnership's QPAI, including any QPAI expenses incurred by the partner directly, with items that are from sources other than the partnership.[113]

110. IRC §§199(d)(1) and (2).

111. Treas. Reg. §1.199-5(d).

112. Ibid.

113. Treas. Reg. §1.199-5(b).

For S corporations, the deduction is determined at the shareholder level. Each shareholder separately computes the DPAD by aggregating their pro-rata share of items allocated to the S corporation's qualified production activities with those items of the shareholder from sources other than the S corporation.[114]

- **Treatment of expenses.** Each partner or shareholder must take into account their distributive share of expenses allocated to the qualified production activities of the partnership or S corporation, regardless of whether the partnership or S corporation otherwise has taxable income. If there are disallowed losses or deductions because of a lack of basis, the at-risk rules, or the passive activity rules, a proportionate share of the losses or deductions that reflect expenses allocated to qualified production activities are suspended as well. Subsequently, when those losses or deductions are released, the partner or shareholder takes into account (in the year they are released) their proportionate share of production activity losses or deductions previously suspended.
- **Special allocations.** A partnership may specially allocate items of income, gain, loss, or deduction allocated or attributable to the partnership's qualified production activities, subject to the normal IRC §704(b) rules, including the rules for determining substantial economic effect.
- **Gain or loss from disposition of interests.** QPAI generally does not include gain or loss recognized on the sale, exchange, or other disposition of an interest in the pass-through entity. Nevertheless, some sales or exchanges of a partnership interest (or distributions treated as a sale or exchange) under IRC §751 might give rise to an item of QPAI being taken into account for the deduction. When §751 applies, it is not clear how to determine when items of QPAI are generated.

> **Note.** Because the DPAD is applied at the partner or shareholder level, the partner or shareholder basis is not reduced as a result of the §199 deduction.

Pass-Through Entities and Qualifying Wages

For pass-through entities, the wage limitation is applied by allocating to the individual (such as a partner) their share of W-2 wages or a portion of the QPAI allocated to the individual for the taxable year.[115]

Partnership and S corporation wages pass through to the Form 1040 for DPAD purposes.[116] Thus, an individual who has a sole proprietorship qualifying farm activity that has no wage expense but who also owns an interest in a partnership or S corporation that expends wages in a qualifying production activity can use the pass-through wages from the partnership or S corporation activity to support a DPAD in connection with the farm proprietorship.

Example 22. Doug is a single farmer with a grain farming operation for which he reports \$50,000 of net Schedule F income in 2013. He pays no wages for this business. Doug is also a partner in a cattle feeding operation that allocates to Doug \$40,000 in total yearly wages and a small net income of \$10,000 annually. The partnership separately allocates all wages attributable to production activity to Doug. Doug's eligible production income is \$60,000 (\$50,000 from Schedule F + \$10,000 for the partnership). Doug's 2013 DPAD is \$5,400 (\$60,000 × 9%) because this is less than half of the W-2 wages allocated to him (\$40,000 × 50% = \$20,000).

A partnership or S corporation that is eligible to use multiple allocation methods (e.g., the simplified deduction method or the small business simplified overall method) to determine QPAI may select either method. Also, **taxpayers can change their allocation method from one year to the next** or make changes in allocating QPAI to owners versus allocating detailed DPGR and attributable expenses.[117]

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114. Treas. Reg. §1.199-5(c).
115. IRC §199(d)(1)(A).
116. IRC §199(d)(1)(A)(iii).
117. Rev. Proc. 2007-34, 2007-23 IRB 1345.

COOPERATIVES

Any person who receives a qualified payment from a specified agricultural or horticultural cooperative is eligible for a DPAD if the cooperative passes a portion of the DPAD to its patrons.[118] A **specified cooperative** is a cooperative that meets both of the following qualifications.

- Part I of subchapter T (IRC §1381) applies.[119]
- The cooperative has MPGE activities in whole or significant part within the United States related to any agricultural or horticultural product, or markets agricultural or horticultural products.

Many nonexempt agricultural cooperatives retain the DPAD for use against their own taxable income. However, many pooling cooperatives (those that operate with marketing agreements requiring members to deliver commodities to the cooperative) elect to pass through the DPAD to their patron-members.

In order for a patron to qualify for the deduction, the cooperative must designate the patron's portion of the DPAD in a written notice mailed by the cooperative to its patrons not later than the 15th day of the ninth month following the close of the cooperative's taxable year.[120] The amount of the patron's DPAD is reported to the patron on Form 1099-PATR, *Taxable Distributions Received From Cooperatives*.[121] A cooperative patron of a federated cooperative may pass the deduction to its member patrons.[122]

Reporting by the Cooperative

The DPAD passed through on Form 1099-PATR is reported on line 23 of the patron's Form 8903 without regard to the taxable income limitation.[123] **The deduction is allowed even if the patron's return does not report net farm income or have wage payments.[124]** A DPAD reported on Form 1099-PATR to a pass-through entity is, in turn, passed on to partners/shareholders as a separate Schedule K-1 item, even if the pass-through entity has a loss or basis limitation.

Several recent IRS private letter rulings have clarified that cooperatives (including grain cooperatives) can elect to treat all commodity payments to members as per-unit retain allocations reflecting not only the apportionment of profit, but the entire amount paid for the purchase of commodities from the agricultural producer. The effect is to allow those cooperatives to calculate QPAI without any cost of sales, so the cooperative's DPAD can be very large.

> **Note.** A cooperative's DPAD is a deduction only against patronage-sourced income and cannot be computed by aggregating patronage and nonpatronage-sourced income.[125]

118. Treas. Reg. §1.199-6(a).
119. IRC §199(d)(3)(F).
120. IRC §199(d)(3)(A)(ii).
121. Treas. Reg. §1.199-6(g).
122. Treas. Reg. §1.199-6(h).
123. Ibid.
124. Treas. Reg. §§1.199-1(a) and (b).
125. FSA 20131802F (Feb. 27, 2013). See also CCM 20132701F (May 16, 2013).

To avoid duplication of benefits, the **patronage dividends and per-unit allocations** received by a patron from a cooperative that are taken into account as part of the cooperative's QPAI may not be taken into account in computing the patron's QPAI from its own activities. This is true regardless of whether the cooperative keeps or passes through the DPAD.[126] Thus, if most of a patron's production is sold to a cooperative, the QPAI computation at the cooperative level virtually eliminates all QPAI at the Form 1040 level.

> **Observation.** If the cooperative passes through the DPAD to the patron, the result may be a much larger deduction than would be possible from a Schedule F net income computation alone.

Cooperatives can elect to pass none, part, or all of their DPAD through to members based on their patronage.[127] The W-2 wage limitation is applied only at the cooperative level, regardless of whether the cooperative chooses to pass through some or all of the deduction. Any amount passed through by the cooperative to its patrons is **not** subject to the W-2 wage limitation a second time at the patron level.[128] If an audit determines (or an amended return reports) that the amount of the DPAD passed through to the patrons exceeded the amount allowable, recapture occurs at the cooperative level.[129]

Reporting by the Producer

A producer can use either of the following methods for reporting per-unit retain allocations.

Method 1. The IRS is issuing matching letters related to per-unit retain amounts and is taking the position that per-unit retain allocations should be reported by the producer on Schedule F, lines 3a/3b, as a cooperative distribution. The amount reported should be subtracted from the producer's gross sales computation.

> **Caution.** Generally, the qualified per-unit retain allocations disclosed by a cooperative on Form 1099-PATR reflect gross sales to the cooperative without a reduction for grain check-off, taxes, storage, and so on. Therefore, this reporting is unlikely to match the patron's (farmer's) reporting.

Thus, if the per-unit retain allocation amount is subtracted directly from gross sales, an expense adjustment normally must be made to the patron's Schedule F expenses to accurately reflect net sale proceeds on the patron's return.

Method 2. In the alternative method, the producer can report total gross sales on Schedule F as usual and only report the per-unit retain allocation on line 3a of Schedule F (and not enter any amount on line 3b). This reporting avoids the hassle of computing the additional expense adjustment discussed under method 1, but it is not the reporting format that the IRS prefers. In any event, the producer must apply the ratio of the nonqualifying gross receipts to total gross receipts to reduce other allocable expenses and wages in computing their personal §199 deduction.

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126. Treas. Reg. §1.199-6(l).

127. IRC §199(d)(3).

128. Treas. Reg. §1.199-6(i).

129. Treas. Reg. §1.199-6(j).

Effect of the 5% Safe Harbor

There is no guidance on the interaction of Treas. Reg. §1.199-6(l) (prohibiting double counting) and the safe harbor under Treas. Reg. §1.199-1(d)(3)(i) that allows all receipts to be treated as DPGR if less than 5% of the taxpayer's total gross receipts are non-DPGR. This raises a question as to whether a patron who qualifies for the 5% safe harbor can include qualified payments from a cooperative in DPGR because all receipts are included under the safe harbor. An alternative interpretation is that Treas. Reg. §1.199-6(l) overrides the 5% safe harbor and excludes the qualified payments from the patron's DPGR. In general, a more specific rule takes precedence over a broader rule if the two rules are in conflict. Because Treas. Reg. §1.199-6(l) is the more specific rule in this case, it would seem to take precedence over the 5% safe harbor.

INCOME AVERAGING FOR FARMERS AND FISHERMEN

Fishermen and individuals engaged in a farm business can elect to average current fishing/farm income over three prior base years to apply lower income tax rates from those prior years.

Income averaging is available for those catching, taking, or harvesting (but not processing) fish, mollusks, crustaceans, and so on. Crew members who are paid a percentage of the catch may also average income. If a taxpayer farms and fishes, the taxpayer must combine income from both sources for averaging purposes.

A farm business, for income averaging purposes, is the trade or business of farming involving the cultivation of land or the raising or harvesting of any agricultural commodity. This includes operating a nursery or sod farm or the raising or harvesting of trees bearing fruit, nuts, other crops, or ornamental trees.[130]

> **Note.** The instructions for Schedule J, *Income Averaging for Farmers and Fishermen,* specify that contract harvesting of a commodity does not constitute a farm business.

Taxpayers who have farm income during the tax year as a sole proprietor, a partner in a partnership, or a shareholder in an S corporation may use income averaging without regard to whether the individual was engaged in a farming business in any prior year.[131]

ELECTED FARM INCOME

Elected farm income (EFI), which is averaged over the prior three years, is the amount of taxable income attributable to any farming business that is specifically elected by the taxpayer as subject to income averaging. EFI includes net Schedule F income; gain from the sale or disposition of property (other than land or timber) regularly used by a farmer for a substantial period in a farming business; and the taxpayer's share of net farm income from a partnership, LLC, or S corporation. Any portion of taxable income attributable to farming may be designated as EFI for averaging purposes. EFI may not exceed taxable income for the taxpayer, and net capital gain attributable to a farming business may not exceed total net capital gain for the taxpayer.

> **Note.** The regulations provide that wages to a shareholder in an S corporation engaged in farming and the landlord's share of a crop-share lease may be included in EFI. It does not matter whether the landlord materially participates in the production of the crop. There must be a written crop-share lease.

130. IRC §263A(e)(4).

131. Prop. Treas Reg. §1.1301-1(b).

EFI includes all income and gains minus deductions and losses (including loss carryovers and carrybacks and nonfarm losses) attributable to an individual's farming business. However, income, gain, or loss from the sale of development rights, grazing rights, and other similar rights are not treated as attributable to a farming business.

In recent years, a significant question has been whether the base income from a prior year can be negative. IRS Pub. 225, *Farmer's Tax Guide,* provides the following answer.

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

IMPACT OF A NET OPERATING LOSS

The final regulations provide that all allowable deductions, including any NOL, are used to determine taxable income for income averaging purposes, even if the result is negative.[132] However, any negative amount that provided a benefit in another taxable year must be added back to the base year taxable amount. Therefore, NOL carried to other years and providing a benefit may not be used.

> **Example 23.** For the 2013 tax year, Frank and Fran elect to average $24,000 of income attributable to a farming business on their joint return. A third of the EFI ($8,000) is added to the 2011 base year income. In 2011, Frank and Fran reported an AGI of $7,400, claimed a standard deduction of $11,600, and a deduction for personal exemptions of $7,400. Therefore, their 2011 base year taxable income is negative $11,600 ($7,400 − ($11,600 + $7,400)). After adding the EFI to the negative taxable income, their 2011 base year taxable income is zero ($8,000 + (−$11,600) = −$3,600). If Frank and Fran elect to income average in 2014, their 2011 base year taxable income for purposes of the 2014 election is negative $3,600.

SAFE HARBOR FOR DISPOSITION OF PROPERTY

A safe harbor exists for the disposition of property after ending a farming business. When a gain or loss from the disposition of property is realized after ending a farming business, the gain or loss is treated as attributable to a farming business if the property is sold within a reasonable time after ending the farming business. A sale or other disposition within one year of ending a farming business is presumed to be within a reasonable time. Whether a sale or other disposition that occurs more than one year after ending the farming business is within a reasonable time depends on all the facts and circumstances.

IMPACT ON OTHER TAXES

Income averaging affects only federal income tax and has no application to employment taxes (FICA, FUTA, SECA, or income tax withholding). When calculating AMT, regular tax liability is determined without regard to farm income averaging. Therefore, taxpayers using income averaging receive the full benefit of the resulting lower tax rates. Income tax is determined by allocating EFI to the base years only after all other adjustments and determinations have been made.

132. Treas. Reg. §1.1301-1(d)(2).

The regulations allow taxpayers with both ordinary and capital gain income who are eligible for income averaging to select how much of the EFI is made up of capital gain or ordinary income.[133] If EFI includes both ordinary and capital gain income, the income must be allocated in equal portions to the three prior years. Capital gains that are included in the income of a prior year do not offset capital losses from that year. They are taxed at the lesser of the capital gains rate or the ordinary income tax rates for the prior year.[134] Net capital losses first offset net capital gains, both farm and nonfarm, before reducing ordinary income.[135]

Note. The rule that capital losses can only offset up to $3,000 of ordinary income per year still applies for purposes of EFI calculations.[136] Thus, a taxpayer can elect to carry back only ordinary income or any combination of ordinary and capital gain income after making these adjustments.

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

Example 24. Kevin and Jane are married and have no dependent children. They use the standard deduction. Kevin's Schedule F income for 2013 is $130,000 and the couple's taxable income is $114,450.

In the past, Kevin and Jane reported taxable income in the 10%–15% brackets. Their taxable incomes for the 2010, 2011, and 2012 tax years are $16,000, $17,000, and $18,000, respectively. They can increase their taxable income for each of the 2010, 2011, and 2012 tax years by approximately $55,000 before they reach the top of the 15% tax bracket.

Kevin and Jane could elect to average all their current farm income and gains and keep the EFI in the 15% bracket. They elect to average $96,600 of income. This removes all their 2013 income from the 25% bracket ($114,450 taxable income − $96,600 = $17,850). This reduces their 2013 tax liability by approximately $4,195, or 10% of the amount moved from the 25% bracket to the 15% bracket ($114,450 taxable income − $72,500 top of 15% bracket).

Example 25. Ken and Jill had the following income for the three base years and 2013.

Year	Income
2010	($ 50,000) (includes $30,000 NOL)
2011	15,000
2012	1,500
2013	150,000

Their EFI for 2013 is $93,000. Ken and Jill must eliminate the NOL from the base year 2010. Therefore, their base year income for 2010 becomes negative $20,000.

After splitting the EFI equally between each of the three base years, their income is as follows.

133. Treas. Reg. §1.1301-1(e)(2)(i).

134. Treas. Reg. §1.1301-1(d)(1).

135. Treas. Reg. §1.1301-1(e)(ii), Examples 3 and 4.

136. Treas. Reg. §1.1301-1(e)(ii), Example 5.

Year	Income	EFI	Income After Adding EFI
2010	($20,000)	$31,000	$11,000
2011	15,000	31,000	46,000
2012	1,500	31,000	32,500

Their tax computations for the three base years and 2013 are as follows.

Base Year	Base Year Income as Adjusted	Share of Elected Farm Income	Income After Share of Elected Farm Income	Income Tax with Farm Income Averaging (Tax Tables)	Income Tax without Farm Income Averaging (10%)	Additional Due to EFI
2010	($ 20,000)	$31,000	$11,000	$1,100	$ 0	$ 1,100
2011	15,000	31,000	46,000	6,054	1,500	4,554
2012	1,500	31,000	32,500	4,009	150	3,859
2013	150,000	(93,000)	57,000	7,654	0	7,654
Total						$17,167

Their 2013 income tax **without income averaging** is calculated as follows.

Income		Bracket		Tax
$ 17,850	×	10%	=	$ 1,785
54,650	×	15%	=	8,198
73,900	×	25%	=	18,475
3,600	×	28%	=	1,008
$150,000				$29,466

By using income averaging, Ken and Jill reduce their income taxes by $12,299 ($29,466 − $17,167).

Example 26. Kyle and Rachel are eligible for income averaging and elect to use income averaging for $45,000 of income in 2011, $60,000 of income in 2012, and $66,000 of income for the year 2013. For years 2008, 2009, and 2010, the base income was $10,000 per year. Their base income for averaging must reflect the additions which occur from their prior income averaging.

	2008	2009	2010	2011	2012	2013
Base Income	$10,000	$10,000	$10,000	$45,000	$60,000	$66,000
2011 EFI	15,000	15,000	15,000	(45,000)		
	$25,000	$25,000	$25,000	$ 0		
2012 EFI		20,000	20,000	20,000	(60,000)	
		$45,000	$45,000	$20,000	$ 0	
2013 EFI			22,000	22,000	22,000	(66,000)
			$67,000	$42,000	$22,000	$ 0

THE AGRICULTURAL ACT OF 2014 (THE 2014 FARM BILL)

ADJUSTED GROSS INCOME

Beginning with the 2014 crop year, producers whose AGI exceeds $900,000 are not eligible to receive payments or benefits from most programs administered by the Farm Service Agency (FSA) and the Natural Resources Conservation Service (NRCS).[137] Previous AGI provisions distinguishing between farm and nonfarm AGI are no longer utilized. The average AGI for crop year 2014 is based on a producer's AGI from 2010, 2011, and 2012.

There are distinctions in how the FSA computes AGI, depending on the type of entity that a producer utilizes.

- For a **C corporation,** the FSA uses line 30 of Form 1120 (taxable income) plus line 19 (charitable contributions).
- For **S corporations,** the FSA only uses line 21 of Form 1120S (ordinary business income or loss).[138]
- For **estates or trusts,** the FSA uses line 22 (taxable income) plus line 13 (charitable deductions) of Form 1041, *U.S. Income Tax Return for Estates and Trusts*.
- For **LLCs, LLPs, limited partnerships (LP), or similar entities,** the FSA uses Form 1065, line 22 (total income from trade or business) plus line 10 (guaranteed payments to partners).
- For **individuals,** the FSA uses Form 1040, line 37 (AGI).
- For **tax-exempt entities,** the FSA uses Form 990-T, *Exempt Organization Business Income Tax Return,* line 34 (unrelated business taxable income) minus income that the Commodity Credit Corporation (CCC) determines to be from noncommercial activity.[139]

As applied, the FSA's computation of AGI is effectively different across entity types. For example, AGI reported by an S corporation (ordinary business income reported on line 21 of Form 1120S) does not incorporate the §179 deduction, due to special allocation rules of Treas. Reg. §1.179-1(f)(2) that require the deduction to be separately stated on the Schedule K-1 and passed through to the shareholders. However, **the §179 deduction is allowed to reduce income on a Form 1120 return for a C corporation.** This produces a lower AGI for a C corporation (as well as an individual) than for an S corporation or an LLC that is taxed as a partnership, even though, in an accounting sense, their income is identical. Thus, because the S corporation rules require the §179 deduction to be separately stated on Schedule K-1 and passed through to the shareholder, an **S corporation is placed at a disadvantage compared to a C corporation.** As a result, the two entities can potentially be treated dissimilarly under the payment limitation rules.

> **Note.** The FSA requires written consent from the individual or legal entity to average AGI based on the individual's or entity's tax return data. This annual AGI certification and written consent are accomplished by completing Form CCC-931, *Average Adjusted Gross Income (AGI) Certification and Consent to Disclosure of Tax Information.*

137. *What's in the 2014 Farm Bill for Farm Service Agency Customers?* United States Department of Agriculture. [www.fsa.usda.gov/FSA/newsReleases?area=newsroom&subject=landing&topic=pfs&newstype=prfactsheet&type=detail&item=pf_20140311_insup_en_fbil.html] Accessed on Jul. 10, 2014.

138. FSA 4-PL Amendment 15 (Feb. 12, 2014).

139. Ibid.

Under the FSA's current AGI computation rules, S corporations and partnerships are at a disadvantage because they cannot apply the separately stated §179 deduction in calculating the entity's 3-year average. This is especially true if the company has years in which the purchase of assets reduced their tax liability, yet has a negative impact on whether they qualify for any of the 2014 Farm Bill programs.

Observation. Although the §179 deduction is presently limited to $25,000 for 2014, it is anticipated that legislation will be enacted that increases the maximum amount to somewhere between $250,000 and $500,000. That will make the FSA's AGI computation rule more of an issue. More C corporations and individuals may become eligible for program payments than S corporations and partnerships.

Example 27. Both the C corporation and the S corporation show identical gross receipts/sales on line 1 of the respective Form 1120 and Form 1120S, which follow. Both corporations claimed the maximum §179 deduction of $500,000 in 2013. The §179 deduction is entered on line 20 of Form 1120. This affects the taxable income for the corporation on line 30, which is the line that the FSA uses to determine eligibility for program payments. For the C corporation, the depreciation deduction has the effect of reducing the corporation's taxable income below the $900,000 threshold.

Conversely, the §179 deduction for the S corporation is not entered on Form 1120S (see line 14). As a result, the S corporation's income exceeds the $900,000 threshold and it is not eligible for payments and benefits from most FSA programs.

For Example 27

Form **1120** Department of the Treasury Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 2013 or tax year beginning ________, 2013, ending ________, 20 ___

▶ Information about Form 1120 and its separate instructions is at *www.irs.gov/form1120.*

OMB No. 1545-0123 **2013**

A Check if:	TYPE OR PRINT		
1a Consolidated return (attach Form 851) ☐		Name: Anyname Corporation	B Employer identification number: 11-1111111
b Life/nonlife consolidated return ☐		Number, street, and room or suite no. If a P.O. box, see instructions.: 1234 Any Name Street	C Date incorporated: 01/01/2012
2 Personal holding co. (attach Sch. PH) ☐		City or town, state, or province, country and ZIP or foreign postal code: Any Where, Iowa 50000	D Total assets (see instructions): $
3 Personal service corp. (see instructions) ☐			
4 Schedule M-3 attached ☐	E Check if: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change		

Income	1a	Gross receipts or sales	1a	1,000,000		
	b	Returns and allowances	1b			
	c	Balance. Subtract line 1b from line 1a			1c	1,000,000
	2	Cost of goods sold (attach Form 1125-A)			2	
	3	Gross profit. Subtract line 2 from line 1c			3	
	4	Dividends (Schedule C, line 19)			4	
	5	Interest			5	1,000
	6	Gross rents			6	
	7	Gross royalties			7	
	8	Capital gain net income (attach Schedule D (Form 1120))			8	
	9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)			9	
	10	Other income (see instructions—attach statement)			10	
	11	**Total income.** Add lines 3 through 10 ▶			11	1,001,000
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (see instructions—attach Form 1125-E) ▶			12	21,000
	13	Salaries and wages (less employment credits)			13	
	14	Repairs and maintenance			14	60,000
	15	Bad debts			15	
	16	Rents			16	
	17	Taxes and licenses			17	
	18	Interest			18	
	19	Charitable contributions			19	
	20	Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)			20	500,000
	21	Depletion			21	
	22	Advertising			22	
	23	Pension, profit-sharing, etc., plans			23	
	24	Employee benefit programs			24	
	25	Domestic production activities deduction (attach Form 8903)			25	
	26	Other deductions (attach statement)			26	
	27	**Total deductions.** Add lines 12 through 26 ▶			27	581,000
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11.			28	420,000
	29a	Net operating loss deduction (see instructions)	29a			
	b	Special deductions (Schedule C, line 20)	29b			
	c	Add lines 29a and 29b			29c	0
and	30	**Taxable income.** Subtract line 29c from line 28 (see instructions)			30	420,000
	31	Total tax (Schedule J, Part I, line 11)				

For Example 27

Form **1120S** | Department of the Treasury Internal Revenue Service

U.S. Income Tax Return for an S Corporation

▶ Do not file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation.
▶ Information about Form 1120S and its separate instructions is at *www.irs.gov/form1120s.*

OMB No. 1545-0130 | 2013

For calendar year 2013 or tax year beginning , 2013, ending , 20

A S election effective date	TYPE OR PRINT	Name: Anyname Corporation	D Employer identification number: 11-1111111
B Business activity code number (see instructions)		Number, street, and room or suite no. If a P.O. box, see instructions.: 1234 Any Name Street	E Date incorporated: 01/01/2012
C Check if Sch. M-3 attached ☐		City or town, state or province, country, and ZIP or foreign postal code: Any Where, Iowa 50000	F Total assets (see instructions) $

G Is the corporation electing to be an S corporation beginning with this tax year? ☐ Yes ☒ No If "Yes," attach Form 2553 if not already filed

H Check if: (1) ☐ Final return (2) ☐ Name change (3) ☐ Address change (4) ☐ Amended return (5) ☐ S election termination or revocation

I Enter the number of shareholders who were shareholders during any part of the tax year . . . . ▶

Caution. Include **only** trade or business income and expenses on lines 1a through 21. See the instructions for more information.

	Line	Description	Box	Amount	Line	Amount
Income	1a	Gross receipts or sales	1a	1,000,000		
	b	Returns and allowances	1b			
	c	Balance. Subtract line 1b from line 1a			1c	1,000,000
	2	Cost of goods sold (attach Form 1125-A)			2	
	3	Gross profit. Subtract line 2 from line 1c			3	
	4	Net gain (loss) from Form 4797, line 17 (attach Form 4797)			4	
	5	Other income (loss) (see instructions—attach statement)			5	1,000
	6	**Total income (loss).** Add lines 3 through 5 ▶			6	1,001,000
Deductions (see instructions for limitations)	7	Compensation of officers (see instructions—attach Form 1125-E)			7	21,000
	8	Salaries and wages (less employment credits)			8	
	9	Repairs and maintenance			9	60,000
	10	Bad debts			10	
	11	Rents			11	
	12	Taxes and licenses			12	
	13	Interest			13	
	14	Depreciation not claimed on Form 1125-A or elsewhere on return (attach Form 4562)			14	
	15	Depletion **(Do not deduct oil and gas depletion.)**			15	
	16	Advertising			16	
	17	Pension, profit-sharing, etc., plans			17	
	18	Employee benefit programs			18	
	19	Other deductions (attach statement)			19	
	20	**Total deductions.** Add lines 7 through 19 ▶			20	81,000
	21	**Ordinary business income (loss).** Subtract line 20 from line 6			21	920,000
	22a	Excess net passive income or LIFO recapture tax (see instructions)	22a			

For Example 27

671113

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0130

Schedule K-1 (Form 1120S) **2013**
Department of the Treasury
Internal Revenue Service

For calendar year 2013, or tax year beginning ________, 2013 ending ________, 20____

Shareholder's Share of Income, Deductions, Credits, etc. ► See back of form and separate instructions.

Part I Information About the Corporation

A Corporation's employer identification number
11-1111111

B Corporation's name, address, city, state, and ZIP code
Anyname Corporation
1234 Any Name Street
Any Where, Iowa 50000

C IRS Center where corporation filed return

Part II Information About the Shareholder

D Shareholder's identifying number
xxx-12-3456

E Shareholder's name, address, city, state, and ZIP code
Typical Taxpayer
1234 Main Street
Any Where, Iowa 50000

F Shareholder's percentage of stock ownership for tax year . . . . **100** %

For IRS Use Only

Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss) **920,000**	13	Credits
2	Net rental real estate income (loss)		
3	Other net rental income (loss)		
4	Interest income		
5a	Ordinary dividends		
5b	Qualified dividends	14	Foreign transactions
6	Royalties		
7	Net short-term capital gain (loss)		
8a	Net long-term capital gain (loss)		
8b	Collectibles (28%) gain (loss)		
8c	Unrecaptured section 1250 gain		
9	Net section 1231 gain (loss)		
10	Other income (loss)	15	Alternative minimum tax (AMT) items
11	Section 179 deduction **500,000**	16	Items affecting shareholder basis
12	Other deductions		
		17	Other information

* See attached statement for additional information.

For Paperwork Reduction Act Notice, see Instructions for Form 1120S. IRS.gov/form1120s Cat. No. 11520D Schedule K-1 (Form 1120S) 2013

CROP INSURANCE

The AGI limitation does not apply for crop insurance purposes, but conservation compliance is required for participation in crop insurance. The conservation compliance requirement applies to crops annually tilled, but permanent crops are not subject to the compliance requirements. Specialty crops and new participants have a phasein period to comply. The phasein period is five years for highly erodible land and two years for wetland. Also, the 2014 Farm Bill allows for margin insurance to be combined with individual crop insurance coverage, and the additional premium subsidy for enterprise units is made permanent. On this point, separate irrigated and nonirrigated enterprise units are available starting in 2015.

The 2014 Farm Bill increases insurance plug yields from 60% to 70%. In an attempt to address declining actual production history due to multiple year disasters, the Farm Bill allows producers to exclude years when their actual yield is less than 50% of the county 10-year average yield. This applies to contiguous counties and allows for the separation of irrigated and nonirrigated acres. In addition, farmers and ranchers will receive an additional 10% crop insurance premium subsidy during their first five years of coverage.

FSA PAYMENT LIMITATIONS

The total amount of payments received, directly and indirectly, by a person or legal entity (except joint ventures or general partnerships) for price loss coverage (PLC), agricultural risk coverage (ARC), marketing loan gains, and loan deficiency payments (other than for peanuts) **may not exceed $125,000 per crop year.** Two payment limits are available if both spouses qualify. A person or legal entity that receives payments for peanuts has a separate $125,000 payment limitation ($250,000 for married persons). Cotton transition payments are limited to $40,000 per year. For the livestock disaster programs, a total $125,000 annual limitation applies for payments under the Livestock Indemnity Program, the Livestock Forage Program, and the Emergency Assistance for Livestock, Honey Bees, and Farm-Raised Fish Program. A separate $125,000 annual limitation applies to payments under the Tree Assistance Program.

C corporations, S corporations, and LLCs all have one payment limitation. The FSA then implements the direct attribution rule down to the shareholders/members at the fourth level for each of the respective entities. Thus, the entity has a limitation and then each member has a limitation. For example, if benefits are sought in the name of an entity and there are four shareholders or members of the entity, there is a single payment limit.

ACTIVE ENGAGEMENT

Producers who participate in the PLC or ARC programs are required to provide significant contributions to the farming operation to be considered actively engaged in farming. Within 180 days of enactment of the Farm Bill, the USDA secretary is to write regulations defining the term "significant contribution of active personal management." The secretary may also set limits for various types of farming operations based on the number of individuals who can be considered actively engaged in farming when the active-engagement requirement is based on a significant contribution of active personal management. However, the regulations do not apply to entities comprised solely of family members.

COMMODITY PROGRAMS

The Farm Bill immediately repeals the Direct and Counter-Cyclical Program (DCP), the Average Crop Revenue Election (ACRE) program, and the Supplemental Revenue Assistance Payments (SURE) program. It replaces them with two programs from which farmers can make a one-time choice.

- PLC
- ARC

Farmers who participate in the PLC or ARC programs for the 2014–2018 crop years have a one-time chance to maintain the farm's 2013 bases through 2018, or reallocate base acres (except for cotton bases — upland cotton is no longer a covered commodity). Base acres will be reallocated to the 4-year average for each covered crop from the 2009–2012 crop years.

Example 28. Guy Wire farms 2,000 acres and usually plants a 50/50 corn and soybeans rotation. However, for 2009–2012, he averaged 1,700 acres of corn and 300 acres of soybeans. Under the Farm Bill, Guy can either keep his old base acres consisting of 1,000 acres of corn and 1,000 acres of soybeans or change it to 1,700 acres of corn and 300 acres of soybeans. Guy's decision depends on whether he believes there is a greater likelihood of receiving more corn payments.

A farmer can update the program payment yield for each covered commodity based on 90% of the farm's 2008–2012 average yield per planted acre, excluding any year when no acreage was planted to the covered commodity. Program payment yields are used to determine payment amounts for the PLC program. In addition, the Farm Bill maintains the current restriction on planting fruits and vegetables on acres that receive commodity payments.

Producers remain eligible for marketing loans under the same repayment terms, except for cotton. The minimum loan rate for cotton is $0.45/pound.

Following is a summary of decisions to be made by producers.

1. Retain or reallocate base acres
2. Retain or update payment yields
3. Program choice

Election of PLC or ARC

As mentioned earlier, farmers have a one-time opportunity in 2014 to elect PLC or ARC for the 2014–2018 crop years. If an election is not made, PLC applies beginning in 2015, with no payment available for 2014. If ARC is elected, **all** producers for a farm (including cash-rent landlords) must sign the election form and actual yields will be shared with landlords.

Cotton acres will not be enrolled in either program. Cotton producers can buy an area-wide, group-risk crop insurance policy known as "STAX." A transition payment is provided at 60% of past payments for 2014 and 36.5% of past payments for 2015. Although it is a one-time election, the FSA will continue to hold an annual sign-up for changes in ownership, AGI, or other necessary information.

All the producers on a farm must make a one-time, unanimous election called the "farm risk management election" of either PLC or ARC at the county level (county ARC) for each covered commodity or an individual ARC for all covered commodities on the farm. If the producers on the farm elect PLC or county ARC, the producers must also make a one-time election to select which base acres on the farm are enrolled in PLC and which base acres are enrolled in county ARC. Alternatively, if individual ARC is selected, then every covered commodity on the farm must participate in individual ARC.

Note. If the sum of the base acres on a farm is 10 acres or less, the producer on that farm may not receive PLC or ARC payments, unless the producer is a socially disadvantaged farmer or rancher or is a limited resource farmer or rancher.

Payments for PLC and ARC are issued after the end of the respective crop marketing year but no earlier than October 1. Thus, the 2014 crop payment will not be made until after October 1, 2015. That means no payments will be received in 2014, other than for ACRE) or other related payments for prior crop years that are normally paid after the crop year. In 2015, producers enrolled in the PLC who also participate in the federal crop insurance program may, beginning with the 2015 crop, make the annual choice as to whether to purchase additional crop insurance coverage called supplemental coverage option (SCO).

PLC. The PLC option works in tandem with a crop insurance SCO. It is a risk management tool that is designed to address significant, multiple-year price declines. It complements crop insurance, which is not designed to cover multiple-year price declines. A farmer who chooses the PLC option will receive a payment (consistent with payment limitations) when the effective price of a covered commodity is less than the reference price for that commodity established in the statute. (For example, the reference price for corn is $3.70 per bushel.) The **effective price** is the higher of the midseason price or the national average loan rate for the covered commodity. Thus, the PLC payment rate is the reference price less the effective price, and the PLC payment amount is the payment rate multiplied by the payment yield multiplied by the payment acres (defined as 85% of base acres).

Example 29. Guy Wire had 1,250 payment acres of corn for 2014, with an average payment yield of 175 bushels per acre. The effective price is $3.25 and the reference price is $3.70. Thus, Guy will receive a PLC payment of $98,437.50 (($3.70 − $3.25) × 175 × 1,250).

SCO provides additional county-level insurance coverage not to exceed the difference between 86% and 100% of the coverage level in the individual insurance policy. Because SCO is a form of crop insurance, payment limits do not apply. However, a farmer selecting the PLC option must pay an additional premium for SCO coverage, 65% of which is taxpayer subsidized.

Note. SCO is not available until the 2015 crop year and is only available to farmers who elect PLC in 2014 (not ARC or STAX). In addition, it is possible to make the election for PLC or ARC on a crop-by-crop basis for purposes of county coverage. However, if ARC is elected for a farm, all crops must be enrolled in the ARC program, and any resulting payments will be based on 65% of the farmer's base acres (instead of 85%). This is known as "individual ARC."

ARC. ARC is a risk management tool that addresses revenue losses. Under ARC, payments are issued when the actual county crop revenue of a covered commodity is less than the ARC county guarantee for the covered commodity. A producer electing ARC must unanimously select whether to receive county-wide coverage on a commodity-by-commodity basis or individual coverage that applies to all of the commodities on the farm. Payment acres are 85% of base acres for county coverage and 65% for individual farm coverage.

Under ARC, a producer must incur at least a 14% loss (defined as 86% of benchmark revenue) for coverage to kick in. The ARC county guarantee is 86% of the previous 5-year average national farm price, excluding the years with the highest and lowest price (the ARC guarantee price), multiplied by the 5-year average county yield, excluding the years with the highest and lowest yield (the ARC county guarantee yield). This guarantee revenue is based on 5-year Olympic production and average crop price excluding the high and low years.

Both the guarantee and actual revenue are computed using base acres, not planted acres. The county-elected ARC payment is equal to 85% of the base acres of the covered commodity multiplied by the difference between the county guarantee and the actual county crop revenue for the covered commodity. Payments may not exceed 10% of the benchmark county revenue (the ARC guarantee price multiplied by the ARC county guarantee yield). Therefore, if revenue is less than 76% of the previous 5-year average national farm price, then the maximum 10% of benchmark revenue is paid, subject to the payment limit of $125,000 per person. Stated another way, ARC applies between 76% and 86% of benchmark revenue, and the payment rate is the lesser of the amount that the ARC guarantee exceeds actual crop revenue or 10% of the benchmark revenue.

Example 30. Pete Moss elects county ARC for 2014. He has 2,000 base acres that he plants with corn. The 5-year Olympic average for corn in his county is 175 bushels per acre, and the 5-year Olympic price is $5.50. His ARC guarantee is $827.75 (175 × $5.50 × 86%). The county final yield was 160 bushels per acre and the average corn price for the 2014 crop year (ending August 31, 2015) is $4.45. Thus, actual county revenue is $712.00 (160 × $4.45). The difference between the guarantee of $827.75 and the actual revenue of $712.00 is $115.75. However, the payment is capped at 10% of the benchmark county revenue, which is $96.25 (175 × $5.50 × 10%). Thus, the actual payment allowed is $163,625 ($96.25 × 2,000 base acres × 85%).

Payments are issued when the total of the actual individual crop revenues for all covered commodities on the farm are less than the total of the ARC individual guarantees for all those covered commodities on the farm. The "farm" for individual ARC purposes includes all the producer's interests in all ARC farms in the state.

The ARC payments can be summarized as follows.

- A farm's ARC individual guarantee equals 86% of the farm's individual benchmark guarantee, which is defined as the ARC guarantee price multiplied by the 5-year average individual yield, excluding the years with the highest and lowest yields, and including all crops on the farm. The actual revenue is calculated in a similar fashion, with both the guarantee and actual revenue computed using planted acreage on the farm.
- The individual ARC payment equals 65% of the sum of the base acres of all covered commodities on the farm, multiplied by the difference between the individual guarantee revenue and the actual individual crop revenue for all covered commodities planted on the farm. Payments may not exceed 10% of the individual benchmark revenue.

Note. Crops for which the producer has elected to receive ARC are not eligible for SCO benefits.

For 2014 and 2015 crops, ARC is more likely to result in a payment to a producer because of the higher Olympic average. However, it may be less likely to result in payments for 2016–2018 crops if prices remain low. If prices remain low, PLC will result in a payment.

The choice for any given producer will be based on different factors (there is no "one size fits all" with respect to the election). ARC may be desired with respect to one crop, and PLC may be best for another crop. Producers of peanuts and rice, for example, will probably want to elect PLC. In general, the bigger the margin is between expected prices and reference prices, the more likely it is that a producer will choose ARC.

Observation. Based on trend yields for corn and soybeans, county ARC in 2014 will reach the cap level in many counties at prices well above the reference prices but below the current USDA projected prices. Individual ARC payments will likely be smaller than county ARC payments. If marketing year prices stay above the corn reference price of $3.70, county ARC provides assistance when the price decreases, but PLC will not. If marketing year prices are extremely low, PLC might provide more assistance. Marketing year forecasts are well above the soybean reference price of $8.40; thus, county ARC provides assistance when the price decreases, but PLC will not. The lower the crop prices are, the more effective the PLC will be.

Producers who enroll their 2015 winter wheat crop in SCO may elect to withdraw from SCO prior to their acreage reporting date without any penalty. This gives producers additional time to make an informed decision on whether to enroll in the ARC or the PLC program. If they choose ARC, they will not be charged a crop insurance premium as long as they withdraw from SCO prior to their acreage reporting date.

Dairy Programs

The Farm Bill eliminates the Dairy Product Price Support Program and the Dairy Export Incentive Program, and it repeals the Federal Milk Marketing Order Review Commission. It extends the Milk Income Loss Contract (MILC) program from October 1, 2013, through the earlier of the date on which the Secretary certifies that the new Dairy Margin Protection Program (DMPP) is operational, or September 1, 2014. Dairy producers who were enrolled in 2013 do not need to reapply. MILC payments are issued when the Boston Class I milk price falls below $16.94 per hundredweight (cwt), as adjusted by a dairy feed ration formula.

The DMPP replaces the MILC and is effective through December 31, 2018. The DMPP offers dairy producers catastrophic coverage at no cost other than an annual $100 administrative fee and various levels of buy-up coverage. **Catastrophic coverage** is available if actual dairy margins fall below the margin coverage levels a producer chooses on an annual basis. The coverage payment is based on the difference between the "all-milk" price and average feed cost per cwt for all milk sold to plants during each 2-month period (explained later). As established by the Farm Bill, **average feed cost** is the sum of the price for:

- 1.0728 bushels of corn, plus
- 0.00735 of a ton of soybean meal, plus
- 0.0137 of a ton of alfalfa.

The margin that a producer can lock in is set between $4 and $8 per cwt.

> **Note.** DMPP payments are not subject to a payment limitation.

A producer can annually select margin protection in $0.50 increments. The coverage percentage is updated annually to reflect average increases in milk production and is based on the highest production history. There is no premium that must be paid if $4 protection is elected. For amounts of margin protection from $4.50 to $8.00, the premium owed is determined on a sliding scale basis. In addition, coverage can be elected between 25% and 90% of production based on prior established production history. The amount of coverage also determines the amount of the premiums.

As established by the Farm Bill, any payment under the program is determined on the **average margin during a 2-month period,** beginning with January–February. If the average margin for any 2-month period drops beneath the elected coverage level (e.g., the average milk price does not exceed the average feed price), a DMPP payment is based on the producer's coverage level and production history.

> **Note.** There is a lower premium available for small producers (generally, 200 cows or less). Also, it costs $0.54 for $0.50 of coverage between $6.50 and $7.00. That would appear to be a typo, but it is in the statute.

Example 31. Rock Pyle milks 1,000 cows that produce 22,000 pounds of milk per year. The average all-milk price for January–February is $16.20. The price of corn is $5.25, soybean meal is $450 per ton, and alfalfa is $300 per ton. Thus, applying the average feed cost, the corn component is $5.63 ($5.25 × 1.0728 bushels), soybean meal is $3.31 ($450 × .00735 per ton) and alfalfa is $4.11 ($300 × .0137 per ton). The result is an average feed cost of $13.05 ($5.63 + $3.31 + $4.11). The margin, therefore, is $3.15 ($16.20 all-milk price − $13.05 average feed cost).

Rock elected $6.00 margin coverage. His production for January–February is 37,000 cwt. Rock's payment will be $105,450 (37,000 cwt × ($6.00 – $3.15)).

The Farm Bill also establishes a new Dairy Donation Program. This program takes effect when average dairy margins are less than $4.00 for two consecutive months. Under the program, the USDA is authorized to buy dairy products for three months or until margins increase above $4.00. For purchased dairy products, the USDA must donate the products to food banks or other nonprofit organizations. The products cannot be sold into commercial markets. The Farm Bill also extends the Dairy Forward Pricing program, Dairy Indemnity program, and the Dairy Promotion and Research program through 2018.

CONSERVATION PROGRAMS

The Farm Bill has several provisions dealing with conservation.

- The Conservation Reserve Program (CRP) is extended through 2018, but the enrolled acres are to be reduced to 24 million by 2018.
- The Conservation Stewardship Program (CSP) is reauthorized at 10 million acres (down from 12.769 million acres) with a payment rate of $18 per acre through 2022.
- The Environmental Quality Incentives Program (EQIP) remains largely unchanged, but funding is reduced. However, the advanced payment for materials and contracting is increased from 30% to 50%.
- The Agricultural Conservation Easement Program (ACEP) combines the Wetlands Reserve Program, Farmland Protection Program, and the Grasslands Reserve Program.

LIVESTOCK

The Farm Bill also contains several provisions that apply to livestock producers. It makes permanent the Livestock Indemnity Program. Payments can be made for fiscal year 2012 livestock losses in excess of normal levels due to adverse weather or attacks by wolves. Payments are made based on 75% of the market value of livestock on the day before death. Excluded, however, is assistance for grazing losses on land used for haying under a CRP contract. The Farm Bill also specifies that the Livestock Forage Disaster program applies beginning in 2012 for a loss of forage due to weather or fire. The payment rate is set at 60% of the value of forage and rises to 80% if the producer collected payments in the previous two production years. EQIP payments are limited to $450,000 between 2014 and 2018. Country-of-origin labeling (COOL) rules were not changed, but the Farm Bill specifies that the USDA is to conduct an economic analysis of the impact of the COOL rules on consumers, producers, and packers.

CODE DEFINITION OF FARMER AND FARMING ACTIVITIES

A farmer is a person engaged in agriculture, raising live organisms for food or raw materials. Farmers include persons engaged in oyster farming; the raising of bees; or the breeding and raising of chinchillas, mink, foxes, and other furbearing animals.[140]

A farm includes a grain, livestock, dairy, poultry, fish, fruit, or truck farm. It also includes a plantation, ranch, range, or orchard.

Farming includes cultivating, operating, or managing a farm for profit, either as an owner or a tenant. A person is not farming if they are engaged only in forestry or the growing of timber.

If the person's main source of income is from providing agricultural services such as soil preparation, veterinary services, farm labor, horticultural services, or management on a fee or contract basis, they must file Schedule C, *Profit or Loss From Business,* or Schedule C-EZ, *Net Profit From Business.*

140. Treas. Reg. §1.6073-1(b)(2); and Rev. Rul. 57-588, 1957-2 CB 305.

WHO IS A FARMER?

The definition of "farmer" is relevant for many sections of the Internal Revenue Code and the Bankruptcy Code. In general, all individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants, are regarded as farmers.[141] The following types of farmers are discussed in this section.

- Decedents
- Landlords
- Trust beneficiaries
- Sellers of sod
- Tobacco growers
- Persons growing ornamental plants
- Persons raising deer

The following activities are specifically **excluded** from the definition of farmer.

- **Farming for recreation or pleasure.** A person cultivating or operating a farm for recreation or pleasure rather than for profit is not a farmer.[142]
- **Raising timber.** A taxpayer engaged in forestry or the raising of timber who is not engaged in the trade or business of timber farming is not a farmer.[143] A taxpayer who sells Christmas trees grown, without planting or cultivation, on land they own is not considered a farmer;[144] depletion rules apply to the trees grown.
- **Selling farm products.** A business or a corporation that sells seed, fertilizer, pesticides, herbicides, and farm hardware to farmers is not a farmer because it does not cultivate, operate, or manage a farm for profit as an owner or a tenant.[145]

Risk

To be classified as a farmer, a taxpayer must meet both of the following tests.[146]

- Participation to a significant degree in the growing process
- Assumption of a substantial risk of loss from that process

Thus, a taxpayer who receives rent based on farm production is considered a farmer. However, if the rent is fixed (rather than flexed),[147] the taxpayer is not a farmer unless they materially participate in the farm's operation or management. Taxpayers are engaged in the business of farming if they are a partner in a partnership that is so engaged.

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141. Treas. Reg. §1.175-3.
142. Ibid.
143. Ibid.
144. Rev. Rul. 54-194, 1954-1 CB 171.
145. *Ward AG Products, Inc. v. Comm'r*, TC Memo 1998-84 (Feb. 26, 1998).
146. Rev. Rul. 69-606, 1969-2 CB 33.
147. See, e.g., *Schuneman v. U.S.* 783 F.2d 694 (7th Cir. 1986).

Decedent

There are many private letter rulings and court cases that illustrate how the definition of a farmer is applied to a decedent. A few of these are summarized here.

- In a 1980 letter ruling,[148] a decedent was deemed a farmer because he had participated in the management of farm operations and his income was based on farm production rather than fixed rental. Tenant farmers operated the farm. The farmer had participated in important farming decisions such as what crop to plant and how to use subsidy payments.
- In a 1981 letter ruling,[149] a decedent was deemed a farmer even though, due to age and infirmity, his son had been running the farm.
- A farm was operated by the decedent or a member of the family until four years before the decedent's death, when he became permanently incapacitated. The decedent's spouse then actively managed the farm. Because the decedent owned an interest in the farm, which was actively managed by his spouse, the decedent was deemed a farmer in a 1981 letter ruling.[150]
- A 1992 court case[151] involved a decedent who had leased his orchard farm for a fixed rental to a family corporation. The decedent was considered a farmer by the court because he was closely involved in both the leasing of his farm properties and the running of the family corporation.

Decedent's Spouse. A decedent farmer's surviving spouse can be considered a farmer by applying the active management test. Under the IRC §2032A(b)(5) test, the active management of a farm by the surviving spouse of the decedent is treated as material participation by the spouse in the operation of the farm. The test must be applied by taking into account any application of IRC §2032A(b)(4), which provides a substitute material participation time period for decedents who were either receiving social security retirement or disability benefits at the date of death. This allows the **surviving spouse's estate** to meet the IRC §2032A(b)(1)(C)(ii) material participation requirements, which stipulate that there must have been material participation by the decedent or a member of the decedent's family for at least five out of the eight years ending on the date of the decedent's death.

Landlords

A landlord is considered a farmer for purposes of farm income averaging with respect to rental income based on a share of production from the tenant's farm.[152] The landlord's crop-share income is eligible for income averaging if the landlord's share of the tenant's production is set in a written agreement before the tenant begins significant activities on the land. If there is no written agreement before significant activities begin on the land, the landlord is not considered a farmer.

Fertilizer and lime are allowable business deductions but are only deductible as an election by a taxpayer who is engaged in the trade or business of farming.[153] Thus, the taxpayer must either be an operator or a landlord under a crop-share lease or livestock-share lease. In addition, the fertilizer or lime must be applied to land that is used in farming. Expenditures on land brought into production for the first time are not eligible for the election to deduct the expense currently. A landlord under a cash-rent lease must amortize the cost of fertilizer and lime unless the landowner is materially participating under the lease.

> **Note.** Crop-share landlords may utilize the IRC §179 expensing election but cash-rent landlords may not.

148. Ltr. Rul. 8020143 (Feb. 26, 1980).
149. Ltr. Rul. 8244003 (May 1, 1981).
150. Ltr. Rul. 8133015 (Apr. 29, 1981).
151. *Gettysburg National Bank v. U.S.,* 70 AFTR 2d 92-6229 (DC PA, 1992).
152. Treas. Reg. §1.1301-1(b)(2).
153. IRC §180.

Special rules apply to landlords for purposes of the special-use valuation of farmland for federal estate tax purposes.[154] In general, although the individual in whose estate the election will be made can cash lease to family members before death, the qualified heirs cannot cash lease the elected land to anyone for the 10-year post-death recapture period.

Trust Beneficiaries

Trust income from farming flows through to the beneficiary for purposes of determining who is a farmer. Thus, when the beneficiary of a trust engaged in farming receives more than 66.67% of gross income from the trust's farming activities, the beneficiary is treated as a farmer.[155]

> **Note.** The definition of a farmer under IRC §6073, which is now obsolete, was similar to the definition provided in IRC §6654(i)(2). The IRS can apply the flow-through rules for purposes of the definition of IRC §6654(i)(2).

Seller of Sod

A person engaged in the sale of sod is considered a farmer.

Tobacco Grower

An individual is a farmer if they materially participate in the growing of tobacco. If they are a landowner who does not materially participate in the operation or management of the farm and are receiving farm rental income based on the tobacco grown, they are not a farmer.

Ornamental Plants

A person engaged in the operation of a plant nursery specializing in growing ornamental plants is considered a farmer.[156]

Raising Deer

A taxpayer who raises or manages deer for ultimate harvest by hunters who pay to come on the property to hunt is considered a farmer.[157]

FARMING ACTIVITIES

This section provides a brief explanation of the following rules as they relate to farming activities.

- Estimated tax payments
- S corporations
- Self employment
- Income averaging
- Conservation contributions
- Soil and water conservation
- Processing commodities
- USDA programs
- Rental income

154. IRC §2032A.
155. Rev. Rul. 80-366, 1980-2 CB 343; and IRC §6073. IRC §6073 was repealed, and Rev. Rul. 80-366 was made obsolete by Rev. Rul. 2004-90.
156. Rev. Rul. 59-12, 1959-1 CB 59.
157. Ltr. Rul. 9615001 (Oct. 17, 1995).

- Cancellation of debt
- Depreciation method
- UNICAP
- Employment
- Excise taxes
- Weather-related livestock sales
- Bankruptcy

Estimated Tax Payments

If a taxpayer engaged in farming activities meets certain conditions, they qualify for more lenient rules for estimated tax payments. An individual is a farmer for purposes of the estimated tax payment rules if their:

- Gross income from farming is at least 66.67% of total gross income from all sources (including passthroughs) for the tax year;[158] or
- Gross income from farming shown on the preceding year's tax return is at least 66.67% of the total gross income from all sources shown on the tax return.[159]

Note. Income received under a cash-rent lease in **not** treated as gross farm income for purposes of the IRC §6654(i) exception to the estimated tax penalty.

Note. For more information about the rules that apply to estimated tax payments for taxpayers engaged in farming activities, see the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 4: Estimated Taxes.

S Corporations

Shareholders. Shareholders receive a pro-rata share of an S corporation's gross income from farming. The character of the S corporation farming income is passed to the shareholders as if they realized the income directly.[160]

Compensation. A shareholder of an S corporation that is engaged in a farming business can treat compensation received from the corporation as farming income if the compensation is paid by the corporation in the conduct of the farming business.[161] A shareholder receiving this income is considered a farmer.

Self Employment

Farmers who materially participate in an agricultural trade or business[162] are subject to SE tax on net earnings. This rule also applies to farm owners and tenant farmers deriving income under a material participation crop-share agreement.[163]

Note. Tobacco quota buyout payments are not subject to SE tax.

158. IRC §6654(i)(2)(A).
159. IRC §6654(i)(2)(B).
160. Rev. Rul. 87-121, 1987-2 CB 217.
161. Treas. Reg. §1.1301-1(e)(1)(i).
162. Treas. Reg. §1.1402(a)-13(c).
163. Treas. Reg. §§1.1402(a)-4(b), 1.1402(a)-13(d), and 1.1402(c)-3(c).

Income Averaging

As mentioned earlier, individuals engaged in a farming or fishing business can elect to spread whatever portion of current income is desired (termed "elected farm income," or "EFI") evenly over three prior taxable years.

> **Note.** The term **farming business** means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodities. It does not include the processing of commodities or products except for those activities that are engaged in a farming business in the prior three carryback years.

Only individuals with farm income are eligible to utilize farm income averaging. For purposes of income averaging available to farmers, the term "individual" does not apply to an estate or trust,[164] and C corporations are not considered individuals. For entities taxed as partnerships that pass through income items to the partners or members, the partners or members should be able to elect income averaging if they are individuals. For S corporations engaged in farming, the character of the income from corporate distributions continues in the hands of the shareholders and does not necessarily have to produce dividends.[165] Likewise, income attributable to a farming business carried on by a partnership can be averaged without regard to the partner's level of participation in the partnership or the size of the ownership interest.[166]

Operators of farming businesses that bear the risks of production and the risks of price change and provide substantial involvement in management are eligible for income averaging. A landlord is not considered engaged in a farming business if the rental is either a fixed rent (cash rent) or a share rent based on a share of a tenant's production determined under an agreement entered into after the tenant has begun significant activities on the land. Whether the landlord materially participates in the tenant's farming business is irrelevant for income averaging purposes. Thus, nonmaterially participating landlords are eligible for income averaging if the landlord's share of a tenant's production is set in a written rental agreement entered into before the tenant begins significant activities on the land. Income from timber farming does not constitute farm income that is eligible for farm income averaging.

> **Note.** An individual is not required to have been engaged in a farming business in any of the base years in order to make a farming income averaging election.[167]

Conservation Contributions of Permanent Easements

The term **qualified farmer or rancher** as it relates to a qualified conservation contribution means a taxpayer whose gross income from the trade or business of farming (within the meaning of IRC §2032A(e)(5)) is greater than 50% of the taxpayer's gross income for the taxable year.[168]

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164. IRC §1301(b)(2).

165. As stated in the statute, "the character of any item included in a shareholder's pro rata share . . . shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation." IRC §1366(b).

166. Summary to TD 8972 (Jan. 7, 2002).

167. Treas. Reg. §1.1301-1(b)(1)(iv).

168. IRC §170(b)(1)(E)(v).

Soil and Water Conservation

A taxpayer engaged in the business of farming may treat the following expenditures as deductible expenses (rather than capital items).[169]

- Expenditures for the purpose of soil or water conservation regarding land used in farming (Under IRC §175(c)(2), the term "**land used in farming**" means land used by the taxpayer or a tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock.)
- Expenditures for the prevention of erosion of land used in farming
- Expenditures for endangered species recovery

Note. A landowner does not qualify for the IRC §175 treatment of soil and water conservation expenses if the landowner leases the subject land under a cash lease.

Processing of Commodities

A member of a cooperative who raises a commodity and sells it to a cooperative for processing is considered a processor of the commodity as well as a farmer.[170] This can impact SE tax and the taxpayer's accounting method.

USDA Programs

Under United States Department of Agriculture (USDA) rules, a farmer must be actively engaged in farming to be eligible for certain farm programs. The farmer can be either an individual or an entity. To be considered "actively engaged in farming," the individual or entity must make a significant contribution to the farming operation of capital, equipment, or land, and a significant contribution of personal labor or active management. Additionally, the individual or entity must share the profits and losses from the operation, and the contributions must be deemed at risk.

From a tax standpoint, a landowner eligible for USDA program payments is also eligible to exclude all or a portion of USDA cost-sharing payments from their gross income.[171] If the landowner is a landlord, it is immaterial what type of lease is involved.

Rental Income

If an individual materially participates in the operations of a farm, the individual is a farmer. If the individual receives rent in the form of crop shares or livestock from a material participation share lease, it is reported on Schedule F and subject to SE tax. Expenses are also reported on Schedule F.

Income and expenses attributable to a nonmaterial participation share lease are reported on Form 4835, *Farm Rental Income and Expenses*. Income attributable to a cash lease is reported on Schedule E, *Supplemental Income and Loss*. Income reported on either Schedule E or Form 4835 is not subject to SE tax. This income may also be subject to the NIIT (discussed earlier in this chapter).

If an individual pastures someone else's livestock and takes care of the livestock for a fee, the individual is considered a farmer and the income is reported on Schedule F. However, if the individual simply rents pasture for a flat cash amount without providing services, the individual is not considered a farmer and must report the rent on Schedule E.

169. IRC §175.

170. IRC §§461(j)(4)(C)(ii) and 461(j)(4)(C)(ii)(ll).

171. IRC §126.

Cancellation of Debt

Farmers in the farming business can exclude from income a canceled debt that is a qualified farm debt. The debt is a **qualified farm debt** if both of the following apply.[172]

- The debt was incurred directly in operating a farm business.
- At least 50% of the total gross receipts for the three tax years preceding the year of the debt cancellation were from the farming business.

The debt must be discharged either by a federal, state, or local government or agency, or by a person who is actively and regularly engaged in the business of lending money and who is independent of the taxpayer.

> **Note.** For more information about qualified farm debt, see the 2013 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Financial Distress.

Depreciation Method

Property that is used in a farming business may be depreciated no more rapidly than the 150% declining balance (DB) method. If a taxpayer is **not** engaged in the trade or business of farming, the 200% DB method of claiming depreciation may be used.

Along with custom harvesting activities, the processing of agricultural commodities, as a distinct business, does not fit within the definition of a farming business for purposes of determining the appropriate depreciation method.[173] For vertically integrated farming operations, only the assets used in the actual raising and harvesting of crops are subject to the 150% DB method.

For assets leased by a nonfarmer to a farmer, the proper depreciation method is determined by the use to which the owner of the asset (lessor) puts the asset rather than the use in the hands of the lessee. However, the appropriate **recovery period** is determined by the end use of the asset by the lessee.

Uniform Capitalization

Under the uniform capitalization (UNICAP) rules of IRC §263A, certain expenses associated with raising plants and animals are not currently deductible. Under §263A, a farmer is engaged in raising a plant or animal, rather than merely reselling a plant or animal, if the plant or animal is held for further cultivation and development before sale. In determining whether a plant or animal is held for further cultivation and development before sale, consideration is given to the following facts and circumstances.

- The value added by the taxpayer to the plant or animal through agricultural or horticultural processes
- The length of time between the taxpayer's acquisition of the plant or animal and the time that the taxpayer makes the plant or animal available for sale
- In the case of a plant, whether the plant is kept in the container in which it is purchased, replanted in the ground, or replanted in a series of larger containers as it grows to a larger size.[174] (However, a plant that is grown by a taxpayer in a container is regarded as a plant produced in a farming business.)

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172. IRC §108(g).

173. A grain harvester who contracts with others to cut and haul their grain for a per acre fee and who does not raise or grow any grain or own the underlying land may use the 200% double declining balance method under MACRS. The harvester merely provides a service by cutting and hauling grain and does not use depreciable property in a farming business. TAM 9748002 (Jun. 27, 1997).

174. Treas. Reg. §1.263A-4(a)(4)(i).

Employment

When employment is considered farming related, the employer must file an annual Form 943. If the requirements are met, the employer must annually file a form 940. If a farmer has a separate nonfarm side business, the wages must be kept separate from the farm wages and Form 941 may need to be filed. A taxpayer is considered an employer of farmworkers if the employees do any of the following types of work.[175]

- Raising or harvesting agricultural or horticultural products on a farm, including raising and feeding of livestock
- Operating, managing, conserving, improving, or maintaining a farm and its tools and equipment
- Performing services related to salvaging timber or clearing land of brush and other debris left by a hurricane (also known as hurricane labor)
- Handling, processing, or packaging any agricultural or horticultural commodity if the taxpayer produced more than half of the commodity (for a group of up to 20 unincorporated operators, all of the commodity)
- Work related to cotton ginning, turpentine, gum resin products, or the operation and maintenance of irrigation facilities

Excise Taxes

Farmers and certain other persons may be eligible to claim a credit or refund of excise taxes on fuel used for any qualified offroad usage in the trade or business of farming. The credit is claimed on Form 4136, *Credit for Federal Tax Paid on Fuels,* and the refund is claimed on Form 8849, *Claim for Refund of Excise Taxes.*

Weather-Related Sales of Livestock

A farm or ranch taxpayer using the cash method of accounting can elect to defer the reporting of gain from excess sales of livestock if the excess sales (i.e., the sales that, under their usual business practices, would not have occurred until the following year) are attributable to drought or other weather-related conditions.[176]

To take advantage of this provision, the taxpayer's principal business must be farming. In a situation involving a rancher who had $121,000 gross income from ranching and $65,000 from nonfarming activities during the tax year, the IRS ruled that the taxpayer's principal business was farming or ranching. The IRS noted that the taxpayer devoted 750 to 1,000 hours per year to the ranch and that his wife contributed approximately 300 hours. Because of drought conditions, the rancher was forced to sell more cattle than his usual business practices would have dictated. As a result, the rancher was eligible to defer the portion of his gain attributable to the excess cattle to the following tax year.[177]

Bankruptcy

Under 11 USC §303(a), an involuntary bankruptcy case cannot be brought against a "farmer" or a "family farmer." 11 USC §101(20) defines a farmer as a "person that received more than 80% of such person's gross income during the taxable year of such person immediately preceding the taxable year of such person during which the case under this title concerning such person was commenced from a farming operation owned or operated by such person." Farming operation includes "farming, tilling of the soil, dairy farming, ranching, production or raising of crops, poultry, or livestock, and production of poultry or livestock products in an unmanufactured state."[178] This definition of farming operation is not an exclusive list of all farming activities, and the definition is not limited to those activities listed in the statute.

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175. IRS Pub. 51, *(Circular A) Agricultural Employer's Tax Guide.*

176. IRC §451(e).

177. Ltr. Rul. 8928050 (Apr. 18, 1989).

178. 11 USC §101(21).

To be eligible for Chapter 12 bankruptcy, a debtor must be a "family farmer" or a "family fisherman" with "regular annual income." A **family farmer** is defined as an individual or a married couple who earned more than 50% of their gross income from farming either for the taxable year preceding the year of filing or during the second and third tax years preceding filing, and whose aggregate debts do not exceed $4,031,575 (as of April 2013).

IN-KIND WAGES PAID FOR AGRICULTURAL LABOR

In-kind wages paid for agricultural labor are not subject to FICA and FUTA tax.[179] Remuneration paid "in any medium other than cash for agricultural labor" is not considered wages.[180] The FMV of the in-kind payment is income to the recipient.

> **Note.** Cash remuneration paid for agricultural labor is also excluded from FICA wages if the employer pays the employee less than $150 for the year and the employer's total agricultural labor expenditures for the year are less than $2,500.[181]

PROPER STRUCTURING OF IN-KIND WAGE PAYMENT ARRANGEMENTS

For in-kind wage payments to be exempt from FICA, FUTA, and income tax withholding, the payment must be in a form that is not readily converted into cash, and the employee must exercise dominion and control over the payment. In late 1994, the IRS issued guidelines concerning the proper structuring of in-kind payment arrangements. Under the guidelines, the validity of a plan for paying wages in-kind is dependent upon a facts and circumstances test. Important factors include the following.

- Whether the commodity (or portion thereof) is properly identified
- Whether there is documentation of the transfer of the item
- Whether the commodity was acquired solely for the purpose of paying wages in-kind
- Whether the in-kind payment was intended to be a substitute for cash (The use of negotiable commodity storage receipts, generic commodity certificates, and deferred payment contracts are likely to be treated as equivalent to cash.)
- Whether the employee negotiated the subsequent sale of the item
- Whether the risk of gain or loss is shifted to the employee after the payment
- The time interval between the employee's receipt of the commodity and sale of the commodity by the employee
- Whether the employee bears the costs incident to ownership of the item (i.e., storage, feeding, insurance, and maintenance costs)

179. IRC §§3121(a)(8) and 3306(b)(11).
180. IRC §3121(a)(8).
181. IRC §§3121(a)(8)(B)(i)–(ii).

The IRS issued several rulings on in-kind wage payments.

- Payment in the form of commodity storage receipts was treated as payment in cash.[182] In the ruling, the value of the storage receipts equaled the amount that the employees would otherwise receive and the employer immediately redeemed the employees' receipts for cash.
- In a situation in which employees were compensated with a percentage of the milk produced, a percentage of the calves, and a percentage of grain production, the corporate dairy operation met the requirements for avoiding payroll taxes.[183]
- In a 1987 ruling, employer-provided livestock given as compensation to employees was considered noncash wages and not subject to FICA tax.[184]
- An arrangement whereby a spouse was compensated with $200 in cash along with 3,000 pounds of live hogs per month was held as a payment in cash when the title to the hogs was transferred to the spouse at the time of delivery to the market.[185]
- In a 1993 ruling, payment to the husband in a family-owned farm corporation in the form of cash wages and 20% of all market-weight butcher hogs produced payments of $6,000 in cash and $34,941 in hogs in one year and $11,000 in cash and $41,272 in hogs another year. The hogs were considered equivalent to the payment of cash compensation.[186]
- In another 1993 ruling, payments of grain to a married couple who were employees of their wholly-owned corporation were treated as the equivalent of cash. Although the couple bore the risk of loss and they marketed their grain themselves, the grain was not removed to separate storage facilities and the couple was not charged for storage.[187]
- In a 1994 ruling, payments of grain to a husband and wife as employees of their farm corporation were treated as the equivalent of cash even though the grain was removed to the employees' own storage facilities and held for periods of five to 60 days.[188]
- In a 2002 case, a farming corporation made payments of hogs to two officers as bonus compensation for labor performed for the corporation. The hogs transferred to the officers were scheduled to be sold by the corporation shortly after the transfer. The officers did not market the hogs separately from those sold by the corporation. Instead, the hogs were transported to market and sold in the same batch as the corporation's hogs and sold to the same buyer on the same terms. The court held that the transfer of the hogs to the officers was a disguised cash transfer with the sole purpose of tax avoidance.[189]

Observation. To avoid having in-kind wage payments subjected to FICA and FUTA tax, the commodity should either be produced in the trade or business or be acquired for use in the trade or business. Likewise, the commodity should not be sold back to the employer. Commodities received and sold at a later date generate a gain or loss to be reported on Schedule D, *Capital Gains and Losses,* or Form 8949, *Sales and Other Dispositions of Capital Assets,* if applicable.

182. Rev. Rul. 79-207, 1979-2 CB 351.
183. Ltr. Rul. 8252018 (Sep. 17, 1982).
184. Ltr. Rul. 8738005 (Jun. 5, 1987).
185. Ltr. Rul. 9136001 (May 14, 1991).
186. Ltr. Rul. 9322003 (Feb. 25, 1993).
187. Ltr. Rul. 9403001 (Aug. 17, 1993).
188. Ltr. Rul. 9428003 (Apr. 5, 1994).
189. *Highway Farms, Inc. v. U.S.,* No. 4-00-CV-80606, 2002 U.S. Dist. LEXIS 4066 (S.D. Iowa, 2002).

REPORTING RULES

The employer recognizes gain from the transfer of the in-kind wages, and may claim a deduction for the in-kind wages paid.[190]

> **Note.** Wages paid in-kind do not count as W-2 wages for purposes of the DPAD, which is discussed in detail earlier in this chapter.

Employees who receive in-kind wage payments can deduct expenses associated with in-kind wage payments on Schedule A, *Itemized Deductions.* It appears that these expenses are subject to the 2%-of-AGI threshold for employee business expenses.

> **Note.** For more information about employee business expenses, see the 2014 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 4: Special Taxpayers.

> **Observation.** A sole proprietorship farming operation may pay cash wages to the sole proprietor's children who are under age 18; these wages are exempt from payroll tax. If the farming operation is operated as a partnership (or an LLC that is taxed as a partnership), the cash wages paid to persons under age 18 are exempt from payroll tax if the only partners (or members) of the entity are the parents of the persons under age 18. If the wages are in-kind wages, they are exempt from payroll tax even if persons other than the parents of the persons under age 18 are partners/members of the farming entity.

TAX ISSUES FOR TIMBER PRODUCERS

A timber seller is either an investor or is engaged in the timber business. For an investor, the resulting gain or loss is capital in nature. However, if the seller is in the trade or business of timber farming, the tax treatment of the sale depends on the amount of timber sold and how the taxpayer chooses to treat the sale.

INVESTORS AS TIMBER SELLERS

For investors, a lump-sum sale of standing timber is treated as a capital gain or loss under IRC §1231. For land that is inherited with standing timber, the holding period is deemed to be long-term irrespective of how long either the taxpayer or the decedent held the land.[191] The timber's basis is its FMV as of the date of the decedent's death (or alternate valuation date under IRC §2032).

> **Observation.** Timber sold shortly after the decedent's death usually results in little or no gain.

TIMBER SELLERS IN THE TRADE OR BUSINESS OF TIMBER FARMING

If the taxpayer cuts timber (or pays to have it cut) and sells the cut timber (and timber products), the gain or loss is subject to ordinary income tax rates unless the taxpayer elects to treat the cutting of the timber as a sale under the provisions of IRC §631(a). The sales are generally treated as occurring in the ordinary course of the taxpayer's business. If the §631 election is made, the difference between the timber's FMV and its basis is §1231 gain or loss that is netted with other §1231 gains or losses for the year. The difference between the net proceeds and the FMV (as of the first day of the tax year) is ordinary in nature.

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190. Treas. Reg. §1.83-6(a)(1).

191. IRC §1223(9).

To qualify for the §631 election, standing timber must be cut by the owner or someone who has held a contract right to cut the timber for more than a year. The holding period must include the first day of the tax year in which timber is cut. The gain or loss is determined based on the FMV of the timber as of the first day of the tax year in which the timber is cut and is reported on Form 4797. The election statement must be attached to the return.

If the taxpayer sells standing timber, the gain or loss is §1231 gain or loss that is netted with taxpayer's other §1231 gains or losses for the year.[192] Net proceeds from annual sales of timber products (e.g., firewood, pine straw) and from sale of timber products after cutting (e.g., tree stumps) is ordinary income or loss.

Note. Sales of standing timber (rather than sales of cut timber) qualify for §1231 treatment regardless of whether they are outright sales or sales with a retained economic interest. The sale amount is reported on Form 4797.

The costs of sale that are directly related to the sale of timber are subtracted from the gross sales price and reduce the gain or increase the loss from the sale. Such costs are deducted along with the basis of the timber when the sale is reported on Form 4797.

TIMBER EXPENSES

The tax treatment of timber-related expenses depends on the type of expense and the tax status of the timber activity.

Uniform Capitalization Rules

If the timber activity involves the raising or harvesting of trees that bear fruit, nuts, or other crops or involves ornamental trees, the timber activity may be subject to the UNICAP rules of §263A. IRC §263A(c)(5) provides an exception from the UNICAP rules for timber and ornamental trees, other than Christmas trees (an evergreen tree that is more than six years old when it is severed from its roots).

Management and Operating Expenses

Ordinary and necessary expenses associated with the daily operation and management of timber property are currently deductible in accordance with IRC §162. This is true even if no income is produced from the property, as long as the timber activity is engaged in for profit[193] and the expenses are directly related to the property's income potential. If the timberland is investment property, management and operating expenses are deductible in accordance with IRC §212. Expenses that are associated with the sale or other disposition of timber are deducted from the sale proceeds.

Management costs are deductible as a miscellaneous itemized deduction on Schedule A by individual taxpayers who hold timber activities as an investment.

Carrying Charges

Carrying charges (taxes, interest, and other expenses that are related to the **development and operation** of timber properties) may be treated as deductible expenses or, by election, may be capitalized. The election is made by attaching a statement to the original return for the tax year for which the election applies. The statement should explain that the taxpayer is electing to capitalize carrying charges and should include sufficient information about respect to the activity to which the charges relate. If carrying charges are not deducted in a particular year, it is **not** assumed that an election to capitalize the costs has been made.

192. IRC §631(b).

193. IRC §183 provides guidance concerning the deductibility of expenses attributable to activities that are not engaged in for profit.

Property taxes (and other taxes attributable to timber operations) are deductible by investors as an itemized deduction that is not subject to the 2%-of-AGI floor. The interest deduction is limited to investment income. Fertilizer expenses are deductible under IRC §194.

Note. Investors can elect to capitalize otherwise deductible carrying charges (such as interest and property taxes) for real property.[194] The election can be beneficial to timber investors in years when miscellaneous itemized deductions that are not related to timber activities do not exceed the 2%-of-AGI floor, which thereby causes the benefit from timber expenses to be at least partially lost. The election to capitalize carrying charges causes the expenses to be added to basis. If the expenses were not capitalized, they would never be recovered for tax purposes.

Development Costs. Expenses for **developing real property** (such as noncommercial thinning and timber stand improvements) constitute carrying charges and must be treated consistently from year to year. It is immaterial whether the property is improved or unimproved, productive or unproductive.

Observation. Generally, it is preferable to not elect to capitalize development costs unless the taxpayer is an investor that rarely meets the 2%-of-AGI threshold for miscellaneous itemized deductions.

If the election to capitalize is made, the carrying charges are allocated to the capital accounts to which the charges apply. Noncommercial thinning and timber stand improvement costs are allocated in full to the timber accounts associated with the timber involved. Holding costs are allocated proportionally among all of the assets, according to the basis of each as of the beginning of the year.

Note. Corporate owners of timber can deduct carrying charges from other corporate income if the election to capitalize is not made.

Holding Costs

Annual property taxes, mortgage interest, insurance premiums, and similar costs can be expensed or capitalized as the taxpayer chooses during any year in which timberland is **unimproved and unproductive. Unimproved real property** is generally defined as land without buildings, structures, or any other improvements that contribute significantly to its value. Timberland is **unproductive** in any year in which it produces no income from any source (such as hunting lease income, timber sales, or sale of forest products from cut timber). The election to capitalize carrying charges characterized as holding costs cannot be made in any year that the taxpayer receives income from the timberland.

Reforestation Expenses

For qualified timber property for which qualifying taxpayers have made an election under IRC §194(b), up to $10,000 of reforestation expenditures can be deducted annually per individual tract of timberland.[195] Reforestation expenditures that are not deducted can be amortized over 84 months using the half-year convention.[196]

Note. Each reforestation project must be separately tracked. The tracking is shown on IRS Form T, *Forest Activities Schedule.*

194. IRC §266.

195. IRC §194(b).

196. IRC §194(a).

For this purpose, **qualified timber property** is a woodlot or other site located in the United States that will contain trees in significant commercial quantities and is held by the taxpayer for the planting, cultivating, caring for, and cutting of trees for sale or use in the commercial production of timber products.[197] **Commercial production** means that the timber is grown for eventual sale to commercial timber processors or for use in the taxpayer's trade or business. In addition, the tract being reforested must be at least one acre in size. Both owned and leased land qualify, and the tract must contain sufficient trees to be adequately stocked for purposes of commercial timber production. Thus, trees grown for personal use do not qualify. Christmas trees do not qualify for the election, irrespective of whether the trees are grown for personal use or for commercial purposes.

Note. Cost-share payments may be available for expenses associated with reforestation activities. Cost-share expenses are excludable in accordance with a formula in IRC §126. However, unless a taxpayer is in a high tax bracket, the taxpayer may be better off to include cost-share expenses in income so as to claim the reforestation deduction (or amortization deduction) on total qualified reforestation expenses.

CASUALTY LOSSES

A deductible **casualty loss** is the complete or partial destruction of property resulting from an identifiable event of a **sudden, unexpected, or unusual nature.** Thus, losses due to hurricanes, floods, tornadoes, wild fires, and similar natural disasters are deductible. However, timber losses due to disease, insect damage, or drought are generally not deductible because they are progressive in nature.

For deductible casualty losses (which are deducted from ordinary income), the loss is the lesser of the decrease in the FMV of a single identifiable property (SIP) or the adjusted basis of the SIP, less any insurance proceeds, salvage value, or other compensation received. In effect, the measure of the loss is the economic loss suffered limited by the basis.

For casualty loss deduction purposes, the **single identifiable property** is any unit of property having an adjusted basis that can be identified in relation to the area impacted by the casualty. Thus, the allowable loss is not limited to merchantable units of timber totally destroyed. Instead, it is also allowed for trees that were damaged but not made worthless.[198] The deductible loss is equal to the difference in FMV of the SIP immediately before and after the casualty, limited by basis.[199]

A casualty loss is claimed in the year that the loss takes place. In addition, costs incurred to substantiate the loss (such as appraisal or timber cruise) are deductible. The loss is reported on section B of Form 4684, *Casualties and Thefts,* and it is then carried to part II of Form 4797. For a casualty loss to timber held as an investment, the loss is reported on Schedule A of Form 1040.

Note. For casualty losses occurring in federally declared disaster areas, the loss can be deducted on an original or amended return for the year immediately **before** the year the disaster took place.

If a gain results from a casualty loss due to proceeds from a salvage sale or other form of reimbursement that exceed the taxpayer's adjusted income tax basis in the timber, the gain can be postponed if the taxpayer acquires replacement property within two years after the end of the first tax year in which the taxpayer realizes any portion of the gain.[200]

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197. IRC §194(c)(1).

198. Rev. Rul. 99-56, 1999-2 CB 676.

199. Thus, for example, it was not correct for a taxpayer to deduct as a casualty loss the difference between the FMV for the volume of timber from each type of affected tree before an ice storm and the reduced FMV for the volume of timber remaining after a storm. FSA 200229007 (Apr. 5, 2002).

200. IRC §1033.

Example 32. Boris owns 80 acres of timber with 1,280 cords of pulpwood-sized timber. Boris's basis in the timber is $10,000. A tornado damaged trees containing 300 cords of wood, such that they must be removed. The tornado damage reduced the FMV of the timber by $2,000. Boris found a buyer willing to pay $4,000 for the damaged timber. Boris calculates the gain from the sale of damaged timber as follows.

Step 1. Adjusted basis in the tract: $10,000

Step 2. Difference in FMV before and after the casualty: $2,000

Step 3. Smaller of steps 1 and 2: $2,000

Adjusted basis in timber after the casualty: ($10,000 − $2,000) ÷ 1,280 cords = $6.25 per cord

Boris has gain on the sale of the damaged timber of $2,125 ($4,000 proceeds – ($6.25 basis × 300 cords)). The $2,125 gain recognition can be postponed if Boris purchases qualified replacement property within two years.

For investors, the loss is a nonbusiness casualty loss. For property held for nonbusiness use, the first $100 of casualty or theft loss attributable to each item is not deductible. The deduction is also limited to the amount that aggregate losses exceed 10% of AGI.[201]

Note. Personal casualty gains and losses from nonbusiness property are netted against each other. If the losses exceed the gains, all gains and losses are ordinary and are subject to the 10%-of-AGI floor. Losses to the extent of gains are allowed in full. All personal casualty losses are subject to the $100 floor **before** netting. If the personal gains for any taxable year exceed the personal casualty losses for the year, all gains and losses are treated as capital gains and losses.

LIKE-KIND EXCHANGES OF TIMBER AND TIMBERLAND

Under the like-kind exchange rules of IRC §1031, a broad definition of "like-kind" for purposes of real estate exchanges is utilized. For instance, undeveloped real estate can be exchanged for developed real estate. The class and type requirements that apply to tangible personal property do not apply with respect to real estate exchanges. However, the real estate must be held for investment or used in the taxpayer's trade or business and not held for sale. Thus, real estate can be exchanged for other real estate as long as the traded properties are held for either a business or investment purpose.

Whether land has timber on it or not is immaterial for purposes of a like-kind exchange.[202] Thus, an exchange of real estate for standing timber or the right to cut standing timber can qualify as a like-kind exchange. To qualify, an interest in standing timber must be treated as real property under state law. In many states, standing timber is considered part of the land.[203]

Note. The quantity, quality, age, and species of timber may relate to the grade or quality of timberland, but these factors have no impact on whether timberland is like-kind to other real estate, regardless of whether the replacement land is timberland.[204]

201. This limitation has been removed for victims of certain hurricanes.

202. See Rev. Rul. 72-515, 1972-2 CB 466; Rev. Rul. 76-253, 1976-2 CB 51; and Rev. Rul. 78-163, 1978-1 CB 257.

203. See, e.g., *Hutchins v. King*, 68 U.S. 53 (1863); *Laird v. U.S.*, 115 F.Supp. 931 (W.D. Wis. 1953).

204. See also Ltr. Rul. 200541037 (Jun. 29, 2005) (fee interest in timberland is "like-kind" to scenic conservation easement); and Ltr. Rul. 8621012 (Feb. 14, 1986) (timberland owned by producer of forest-related products can be exchanged for bare land).

For like-kind exchanges involving timberland, a key case is *Oregon Lumber Co. v. Comm'r*.[205] In this case, a timber harvesting company exchanged timberland for the right to cut certain timber marked for cutting on other timberland owned by the United States. The exchange agreement contained a provision obligating the exchanger to cut certain timber marked for cutting within a specific time period. The Tax Court held that the conveyance was not like kind because Oregon law treated the right to cut timber as a right to acquire goods only (personal property), and, under the exchange agreement, the right to cut timber was limited in duration. Timberland is not like kind to the right to cut timber on someone else's land.[206]

The key considerations regarding exchanges can be summarized as follows.

- Does the state law have any provisions about timberland and timber interests?
- Under state law, are rights to cut timber in the nature of a service contract or a property right?
- Is the timber right that is being conveyed limited in duration, or is it perpetual (e.g., fee simple)?
- Are the rights to harvest timber conveyed by deed? Are they conveyed by bill of sale? Are they conveyed by a license?[207]
- Does the conveyance instrument contain any obligation to cut and remove timber?

205. *Oregon Lumber Co. v. Comm'r,* 20 TC 192 (1953).

206. See also TAM 9525002 (Feb. 23, 1995)*,* in which the IRS considered whether an exchange of standing timber and cut timber located on 60 acres owned by the exchanger for a fee interest in three parcels of timberland qualified as a like-kind exchange. The IRS determined that it did not. The relinquished property was conveyed by a "timber deed" of all standing and cut timber located on 60 acres that would be removed within a specified period with any remaining timber reverting to the exchanger and constituting personal property. The 2-year contract period amounted to a de facto restriction on the number of trees that could be removed. Thus, the duration of interests was dissimilar.

207. For a license, see *Smalley v. Comm'r,* 116 TC 450 (1994). In *Smalley*, the issue was whether the taxpayer had constructive receipt of a payment for purposes of the installment sale rules. The taxpayer sold "the exclusive license and right to cut all merchantable pine and hardwood timber suitable for poles, saw timber, or pulpwood" on 95 acres of land. Under the contract terms, the buyer paid the purchase price to an escrow agent so that the taxpayer could complete a deferred exchange. The court held that if the taxpayer had a bona fide right to complete a like-kind exchange, then the taxpayer did not have constructive receipt of the payment to an escrow agent, even if he did not acquire like-kind property within the replacement period. The court did not provide any analysis of whether like-kind property was involved but did state that it was reasonable for the taxpayer to believe that the proposed transaction would qualify as a like-kind exchange. State law (Georgia) specified that standing timber that the buyer severs constitutes a transfer of real property.

AGRICULTURAL RULINGS AND CASES

Cash Accounting and Farming Syndicate Rule

***Burnett Ranches, Limited v. U.S.*, U.S. Court of Appeals, 5th Circuit; No. 13-10403. 753 F.3d 143 (5th Cir. 2014)**
IRC §464

The IRS sometimes challenges taxpayers that are believed to be distorting income reporting by use of the cash method of accounting. This case involved a Texas cattle and horse breeding limited partnership that the IRS claimed was a tax shelter by virtue of being a "farming syndicate" and, therefore, was not entitled to use the cash method.

In the farm and ranch sector, an alleged distortion of income often arises in the context of prepayment for inputs such as fertilizer, seed, feed, and chemicals. Various tests and rules have been adopted over the years to deal with material distortions of income when prepayments are involved.[208] One of those rules, which is designed to place a limitation on deductions for farming operations, was developed in the 1970s and is known as the **"farming syndicate rule."[209]** Congress enacted the rule in 1976, and it forbids farming syndicates from taking deductions for feed, seed, fertilizer, and other farm supplies before the year in which the supplies are actually used or consumed. The rule establishes two tests for determining whether a farming syndicate exists. A farming syndicate is:[210]

- A partnership or other enterprise (except a regularly taxed corporation) engaged in farming if any sale or offered sale of ownership interests in the firm has required registration with any federal or state securities agency, or
- A partnership or other enterprise (other than a C corporation) engaged in farming **if more than 35% of the losses during any period are allocable to limited partners or limited entrepreneurs.**

> **Note**. The farming syndicate rule does not affect many farming and ranching operations, but it does catch some extremely large operations and a few individuals who are inactive investors in farming operations. This is because there is an exception to the rule for holdings attributable to **"active management."** If an individual has actively participated (for a period of not less than five years) in the management of the farming activity, any interest in a partnership or other enterprise that is attributable to that active participation is deemed to **not** be held by a limited partner or a limited entrepreneur.[211] **If the taxpayer's interest satisfies the active management test, the interest does not count toward the 35% test.**

In the IRS's view, the exception for active management only applies to an individual.[212] Thus, in CCA 200840042,[213] the Office of Chief Counsel determined that a partnership interest held by an S corporation with only one shareholder was to be treated as held by a limited partner for purposes of the farming syndicate rule. In the case addressed by this Chief Counsel Advice, the partnership raised and bred livestock, and its members were two trusts along with the S corporation. The S corporation was owned by a trustee who was also a beneficiary of the trusts. One of the trusts was the general partner of the partnership. The partnership reported income using the cash method, but the IRS took the position that the partnership interest that the S corporation held had to be treated as a limited partnership interest because it was not held by an individual. This was the result, according to the IRS, even though the S corporation's sole shareholder was an individual. Thus, for purposes of the farming syndicate rule, the interest held by the S corporation was treated as an interest that was held by a limited partner.

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208. See, e.g., Rev. Rul. 79-229, 1979-2 CB 210.
209. IRC §464(c).
210. IRC §464(c)(1).
211. IRC §464(c)(2)(A).
212. IRC §464(c)(2)(A) states "in the case of any individual who has actively participated . . ."
213. CCA 200840042 (Jun. 16, 2008).

In *Burnett Ranches, Limited v. U.S.*, the court held that the ranch qualified for the active participation exception even though the majority owner actively participated in managing the cattle operation through the owner's wholly-owned S corporation. The court noted that the west Texas operation had been family-run for many generations, dating back to the 1800s, with the current majority owner family member owning her interest via an S corporation. There was no question that the majority owner managed the operation and satisfied the active management test in her own right. However, the IRS contended that the farming syndicate rule was triggered and cash accounting was not available because the ownership interest was held in an S corporation rather than directly by the majority shareholder as an individual. Consequently, the partnership could not use cash accounting for the years in issue (2005–2007). The limited partnership paid the alleged deficiencies and sued for a refund in federal district court. The district court ruled for the limited partnership.

The IRS appealed, continuing to maintain that the majority owner's interest in the limited partnership via her S corporation interest barred the active management exception from applying. The U.S. Court of Appeals for the 5th Circuit disagreed, largely on policy grounds. The court noted that the **Congressional intent behind the active management exception was to target high-income, nonfarm investors, not the type of taxpayer that the majority owner in *Burnett Ranches* represented.** The court noted that the statutory term interest was not synonymous with legal title or direct ownership, but rather was tied to involvement with or participation in the underlying business.

Thus, the court determined that there was no basis for distinguishing between "the partnership interest of a rancher who has structured his business as a sole proprietorship and a rancher who has structured his business as [a subchapter S] corporation." The term "individual" was used in the statute to refer to the provision of active management rather than in reference to having an interest in the activity at issue. **The court underscored its holding by noting that the majority owner's "business and ownership history with these ranches is the very antithesis of the 'farming syndicate' tax shelters that §464 was enacted to thwart."**

Perpetuity Requirement

Patrick and Louise Wachter v. Comm'r, **142 TC No. 7 (Mar. 11, 2014)**
IRC §170

A charitable deduction for a conservation easement is not allowed unless numerous requirements set forth in IRC §170 are satisfied. Among those requirements is that the contribution be "exclusively" for conservation purposes. Exclusivity is not satisfied unless the conservation purpose of the easement is protected in perpetuity.[214]

In *Wachter v. Comm'r*, a married couple held interests in two partnerships. One entity reported cash contributions to North Dakota Natural Resource Trust (NRT) of $170,000, $171,150, and $144,500 in the years at issue. The other entity reported bargain sales of conservation easements as charitable contributions in the amounts of $349,000, $247,550, and $162,500 for the years at issue. The easements were in accordance with a 2002 Farm Bill program designed to protect topsoil. However, under North Dakota state law, easements are limited to a maximum duration of 99 years. As a result, the court determined that the easements were not perpetual because there was a certain time at which the easement would terminate. Therefore, the transaction did not qualify as a deductible conservation easement donation.

The taxpayers argued that the 99-year-lease case law involving IRC §1031 should apply. Under those rules, a leasehold interest with a term of at least 30 years remaining at the time the exchange transaction is entered into is like-kind to a fee simple interest in real estate. **The court held that the §1031 rules were inapplicable because of the lack of a perpetuity requirement in §1031.**

214. IRC §170(h)(5)(A); and Treas. Reg. §1.170A-14(a).

Valuation

Esgar Corp. et al. v. Comm'r, **U.S. Court of Appeals, 10th Circuit; No. 12-9009 744 F.3d 648 (10th Cir. 2014),** ***aff'g Esgar Corp. v. Comm'r,*** **TC Memo 2012-35 (Feb. 6, 2012);** ***Tempel v. Comm'r,*** **136 TC No. 15 (Apr. 5, 2011)**
IRC §170

A conservation easement's FMV is determined on a case-by-case basis using one of two approaches. Under the first approach, the easement is valued by reference to amounts paid for comparable conservation easements. The second approach, used when comparable easements are not available, considers an easement's value to be the difference between the value of the property before the easement restriction and the value of the property after the easement restriction is imposed. A key to being able to deduct the full amount of the claimed deduction is obtaining thorough and accurate appraisals.

Esgar Corp. v. Comm'r involved the appropriate valuation of donated conservation easements. The specific issue was whether the "highest and best use" of the land subject to the easements was gravel mining or agricultural use as irrigated farmland. The taxpayers, a corporation and two couples, owned land with another corporation in undivided one-fourth interests. The 1,560-acre tract was partially used for gravel mining. The taxpayers conducted a series of like-kind exchanges that involved approximately 163 acres not zoned for mining gravel. After the transactions, each taxpayer owned about 55 acres outright. The taxpayers sought to donate conservation easements on the tracts. Each taxpayer claimed a charitable contribution based on appraisals under the "before and after" approach. The taxpayer claimed that the highest and best use of the tract was for gravel mining. The IRS denied the deductions.

The Tax Court determined that the highest and best use of the land was for agricultural use. This lowered the value of the property before imposition of easement restrictions, which, in turn, resulted in a deduction of $100,000 rather than $2 million. The Tax Court noted that the highest and best use of any land is its current use, unless the taxpayer shows a compelling reason for a different use. If an alternative use is to be accepted, the court noted, the taxpayer must show that it is a reasonably probable use that has an actual market value. As applied to mineral extraction, the court noted that the taxpayer must establish that a market exists that would justify extraction in the reasonably foreseeable future rather than simply show that the property can be adapted to mineral extraction. Here, the court found that there was no unfilled demand, that the taxpayer had overstated the demand for gravel, and that the gravel market could not reasonably be anticipated to change in the foreseeable future. Thus, the court based the value of the properties on comparable sales of agricultural property with comparable water and access rights.

On appeal, the U.S. Court of Appeals for the 10th Circuit affirmed. The court found no difference between conservation easement valuation and just compensation valuation in the context of determining the highest and best use of a particular property.

An additional issue involved the state of Colorado granting the taxpayers $260,000 of transferrable income tax credits for the donation of the conservation easement. The taxpayers sold the credits and claimed that the credits triggered capital gain because the credits were part of the land and that part of the land's income tax basis should be allocated to the credits, along with the professional fees they incurred in selling them. Although the court agreed that the credits were capital assets, it determined that the taxpayers did not have any income tax basis in the credits because the taxpayers' rights in the credits were not a right in the land and arose **after** the state granted the credits. Under Colorado law, the taxpayers did not have any contract right in the credits. The taxpayers' holding period in the credits began at the time the credits were granted and ended upon their sale. The taxpayers sold the credits in the same month that they were granted, resulting in short-term gain. The court indicated that if the taxpayers had actually used the credits to offset their state income tax liability, the credits likely would not have constituted income to the taxpayers.

Special-Use Valuation Consent Agreements: Doctrine of Consistency

***Brett Van Alen v. Comm'r,* TC Memo 2013-235 (Oct. 21, 2013)**

IRC §§2032A and 1014

IRC §2032A allows the executor of a decedent's estate to list the value of the decedent's farmland on the estate tax return at its agricultural-use value rather than its FMV. The executor must make an election to do this and can select the farmland that is subject to the election. Numerous requirements must be satisfied by the decedent before death for the estate to be eligible to make the election, and the farmland and farm personal property must make up a sufficient portion of the total value of the property in the estate. In addition, the heirs who inherit the land must continue to farm the land for 10 years after the decedent's death. If the elected land is not farmed for 10 years, the tax benefits to the estate of the election are forfeited, and interest is added.

To make the election, the estate's executor must file an agreement signed by each person who has an interest in the elected property. In this agreement, the heirs consent to the election, agree to personal liability for any additional taxes imposed as a result of the sale of elected property or the cessation of qualified use within that 10-year post-death "recapture" period.

The heirs' income tax basis in the elected land is the special-use value of the property as reported on the estate tax return.[215] This is different from the general rule that persons who inherit property get an income tax basis in the inherited property equal to its value reported for estate tax purposes.

Note. In 1954, the IRS said that a taxpayer can challenge the reported value of property for estate tax purposes if the taxpayer has clear and convincing evidence that the reported value was wrong, unless the taxpayer is barred by previous conduct.[216] However, since that time, the courts have utilized a "duty of consistency" that prevents a taxpayer from making an inconsistent representation after the expiration of the statute of limitations that the IRS had relied on if the outcome of the taxpayer's position would not be in the IRS's favor.

In *Brett Van Alen v. Comm'r,* the petitioners were two children of a 1994 decedent and were beneficiaries of a residuary testamentary trust that received most of the decedent's estate, including a $^{13}/_{16}$ interest in a 2,345-acre cattle ranch. Their stepmother was the executor. The FMV of the ranch was determined to be \$1.963 million at the time of the decedent's death, but was reported on the estate tax return at less than \$100,000, in accordance with IRC §2032A.

Note. That dramatically reduced value was incorrect because it far exceeded the total value reduction that was possible under the §2032A rules. However, the IRS allowed it as the result of a trade-off for higher estate tax values on other nonelected parcels.

The petitioners signed a consent agreement (via a guardian ad litem). Years later, the trust sold an easement on the ranch for \$910,000 that restricted development on the property. The easement transaction generated capital gains, and the estate calculated the gains based on the §2032A value. The estate issued Schedules K-1 showing that the proceeds had been distributed to the beneficiaries. The beneficiaries did not report the gain as reflected on the Schedules K-1, asserting that the ranch was mistakenly undervalued on the estate tax return and, thus, the gain reportable should be reduced by using a FMV income tax basis. The court noted, however, that §2032A determines the income tax basis in accordance with IRC §1014(a)(3).

215. IRC §1014(a)(3).

216. Rev. Rul. 54-97, 1954-1 CB 113.

Importantly, the court determined that the heirs (who were not the estate's executors) were bound by a "duty of consistency" to use the value of the property as reported on the decedent's estate tax return as their income tax basis. The court noted that the IRS had relied on the values as stated on the estate tax return and **that the petitioners were trying to change that representation to the detriment of the IRS after the statute of limitations for the estate tax return had expired.** Accordingly, Rev. Rul. 54-97 did not apply. The court also noted the "unequivocal" language of §1014(a)(3), which states that the basis of property acquired from a decedent is "in the case of an election under section 2032A, its value determined under such section."

Observation. The case law clearly supports the notion that the "duty of consistency" establishes basis in an heir's hands as the estate's tax value of the inherited property if the heir was also a fiduciary of the estate. However, the court expanded the application of the doctrine to nonfiduciary heirs by citing three cases, all of which applied the doctrine to an heir who was also a fiduciary of the estate.

Another problem with the court's opinion is that the audit of the estate went, as the court described it, "back and forth." Estate tax audits are often characterized by negotiations, and it is possible in this case that the special-use value for the ranch property was permitted to be lower than what was allowed by statute as a trade-off for higher values on other nonelected property in the estate. The result was that the estate's executor and the IRS negotiated estate tax values on elected and nonelected land that were not representative of actual FMV of the nonelected property or a special-use value for the elected land that was within the statutory limitation. Binding the nonfiduciary heirs (such as the petitioners in this case) to the outcome of negotiations between the executor and the IRS seems to be unfair, but apparently the signed consent agreement trumps that concern.

Bonus Payments

***Michael and Brenda Dudek v. Comm'r,* TC Memo 2013-272 (Dec. 2, 2013)**

IRC §§612 and 613A

In *Michael and Brenda Dudek v. Comm'r,* the taxpayer received $883,250 as an up-front bonus payment to allow an oil and gas company to lock up his property for an eventual lease. The taxpayer treated the amount as capital gain and argued that a sale rather than a lease was involved. The IRS claimed that the amount was ordinary income; it assessed additional tax of $147,397 and imposed an accuracy-related penalty of $29,479. The Tax Court agreed with the IRS that ordinary income treatment should apply, primarily because the agreement between the parties clearly denoted the transaction as a lease under which the taxpayer retained an economic interest in oil and gas deposits. Because of that retained interest, the transaction did not constitute the sale of a capital asset.

The Tax Court also held that the bonus payment was not eligible for percentage depletion under IRC §613A because the intent of the bonus payment was to incentivize the taxpayer to enter into an eventual lease rather than as a payment for the extraction or production of oil and gas. Importantly, no well had yet been drilled on the property at the time the taxpayer received the bonus payment. Although the bonus payment was eligible for cost depletion under IRC §612, the taxpayer did not produce sufficient evidence of the amount of the expected royalties.

Hobby Losses

Merrill Roberts v. Comm'r, **TC Memo 2014-74 (Apr. 29, 2014)**
IRC §183

Under the hobby loss rules, a taxpayer is not entitled to a deduction attributable to any activity that is not engaged in for profit. Whether an activity is a hobby is determined on a facts and circumstances basis in accordance with nine factors that courts and the IRS have developed over time. Under IRC §183(d), if a taxpayer has gross income in excess of deductions from an activity for three or more of the last five years, the taxpayer is presumed **not** to be engaged in a hobby activity. For activities consisting of breeding, training, showing, or racing horses, the presumption arises if there is a profit in any two of the last seven years. The IRS can rebut the presumption by establishing a lack of profit motive.

In *Merrill Roberts v. Comm'r*, the taxpayer had prior success as a nightclub owner at the time he acquired property on which horses were boarded. He held the property for two years on the belief that it would appreciate in value. After relocating to another property, the taxpayer built a first-class training facility, hired experts, and educated himself concerning racing strategies. He devoted substantial time to his horse-related activities. His peers asked him to become a leader in professional horse racing organizations, and he also lobbied politicians on behalf of horse racing interests. The taxpayer's recordkeeping system, although not sophisticated, did aid him in operating his horse-related activities. He suffered losses during the start-up phase of the horse-related activities, some of which were beyond his control. However, he also enjoyed periodic success and even had one of his horses nominated to run in Triple Crown races. The facts showed that the taxpayer enjoyed the horse-related activities, but, as time passed, he became more engaged in the more mundane aspects of the activity.

Based on the facts, the court determined that the taxpayer had the requisite profit intent after moving to the new property. The result was that the taxpayer's losses were disallowed for the first two years at issue but were allowed for later years.

> **Note.** For more information about this case, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Rulings and Cases.

Computing Gain on Reacquisition of Real Estate

Marvin Debough v. Comm'r, **142 TC No. 17 (May 19, 2014)**
IRC §§1038 and 121

Under IRC §1038, if the seller of real property repossesses the property in satisfaction of a debt secured by that property, generally the reacquisition does not result in gain or loss to the seller, and the debt does not become worthless or partially worthless.

> **Note.** The rule bars a taxpayer from claiming any loss on reacquisition. However, there is an exception when a principal residence is repossessed and resold within one year.

Under §1038(b), however, gain on a reacquisition results to the extent that the amount of money (and the FMV of other property, excluding the buyer's obligations) received before the reacquisition exceeds the amount of gain on the sale of that property reported for periods before the repossession. This includes any portion of the tax year of reacquisition.

In *Marvin Debough v. Comm'r*, the taxpayer sold his 80-acre mixed-use property and home on the installment basis for a gain of $657,796. The taxpayer calculated the gain by excluding $500,000 of gain attributable to the sale of a home under IRC §121. The buyer defaulted in the third year after the sale, and the taxpayer reacquired the property in full satisfaction of the debt. The taxpayer did not resell the residence within a year after reacquiring the property. The IRS claimed that the taxpayer had to recognize gain upon repossession, to the extent of money and other property received before the repossession. The IRS position had the effect of recapturing the §121 exclusion that the taxpayer had previously claimed.

The Tax Court determined that the principal residence exclusion of §1038(b) did not apply because the taxpayer did not resell the residence within one year of the reacquisition. Thus, the general rules of §1038 applied. The payments the taxpayer received before the reacquisition were included in the taxpayer's income even though, in the original sale, the taxpayer excluded amounts attributable to the personal residence under §121. The court was persuaded that Congress understood the relationship between §1038 and §121 and that the result was consistent with basic principles of federal tax law inasmuch as the installment payments were a clear accession to wealth that should be included in the taxpayer's income. The court noted that the taxpayer was actually in a better position than before the sale, because he not only owned the residence but also had the cash received as installment payments.

Observation. Upon reacquisition of the residence, the taxpayer is still required to meet the 2-out-of-5-year ownership and use test. That could be difficult to satisfy in many reacquisition situations unless the taxpayer moves back into the residence. If the test is not met, the taxpayer might be able to satisfy the requirements for a reduced exclusion. The reacquisition also causes an increase in the basis of the residence to the extent of the gain recognized on repossession, which will result in less gain on an eventual resale.

Note. This case has significance for installment sales of farm property in which a personal residence is included and the property is subsequently repossessed.