Chapter 4: Agricultural Issues and Rural Investments

Please note. Corrections were made to this workbook through January of 2016. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as shortURLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

CASH METHOD OF ACCOUNTING[1]

Cash method taxpayers generally can deduct their expenses for the tax year in which they are paid.[2] The U.S. Supreme Court has acknowledged that the cash method for farmers is "an historical concession by the Secretary and the Commissioner to provide a unitary and expedient bookkeeping system for farmers and ranchers in need of a simplified accounting procedure."[3]

PREPAID EXPENSES

It is beneficial for farmers to prepay for supplies for both business and tax purposes. If structured properly, prepayment provides deductions in the year of the payment, favorable prices may be received, and harvesting may be more efficient due to having adequate input supplies on hand. To properly structure prepayments, the expenditure must be an actual payment rather than simply a deposit,[4] and the prepurchased materials or supplies must be used within the next year to avoid a conflict with the IRS about whether the expense should be capitalized.[5]

A "farm syndicate" is not allowed to deduct supplies until actually used or consumed.[6] In addition, farmers may not deduct prepaid farm supplies in excess of 50% of the otherwise deductible farming expenses (the "50% rule").[7]

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1. Special acknowledgement is given to Chris Hesse, principal with CliftonLarsonAllen, CPAs, Minneapolis, MN, for assistance with authorship, comment, and review of this section.
2. IRC §461(a); Treas. Reg. §1.461-1(a)(1).
3. *U.S. v. Catto,* 384 U.S. 102 (1966).
4. Rev. Rul. 79-229, 1979-2 CB 210.
5. *Zaninovich v. Comm'r,* 616 F.2d 429 (9th Cir. 1980), *rev'g,* 69 TC 605 (1978).
6. IRC §461(h)(2)(A)(iii). IRC §461(j)(4) contains the definition of a "farming syndicate" and IRC § 461(j)(5) defines "economic performance" for tax shelters. The farm syndicate rules were moved from IRC §464 by the Tax Increase Prevention Act of 2014, PL 113-295.
7. IRC §464(f).

2015 Tax Court Opinion

In recent years, the IRS has indicated its opposition to the cash method of accounting for farmers. Litigation involving a California farming operation using the cash method and prepaid expenses has been ongoing for several years. In *Agro-Jal Farming Enterprises, Inc., et al. v. Comm'r*,[8] the plaintiff raised strawberries and vegetables. It used field-packing materials such as plastic clamshell containers and cardboard trays and cartons in its in-field packing process. It purchased these materials in bulk, in advance of the harvest. The supplies not used by yearend were reflected as expenses in its accrual basis financial statements in the year consumed, rather than when paid. The Tax Court was faced with the issue of whether the plaintiff could deduct the packaging materials in the year the materials were paid for or whether they could only deduct the amounts as the materials were used.

Note. The plaintiff reported its income for tax purposes on the cash basis but prepared GAAP financial statements for financing purposes. The plaintiff also kept detailed records of the field packaging materials on hand at the end of the year, which it capitalized on its yearend financial statements.

The IRS conceded that cash method farmers may deduct farm supplies immediately upon purchase but argued that the farming syndicate rules limited an immediate deduction for expenses attributable to "feed, seed, fertilizer or other similar farm supplies." It asserted that the plaintiff's field packing materials were not "other similar farm supplies" for this purpose. The IRS cited the 50% rule of IRC §464(f) for the definition. However, if the field packing materials were farm supplies under this provision, the 50% limit would not be exceeded, and their cost would be fully deductible. In essence, the IRS argued that only feed, seed, fertilizer, or other similar farm supplies may be deducted immediately upon purchase but that all other supplies could only be deducted as consumed.

The plaintiff presented two counter-arguments. The first was that the field packing materials constituted "other similar farm supplies." The second argument, based upon the farm syndicate rules, was that only those farmers who met the definition of a farming syndicate were barred from using cash accounting. Because Agro-Jal did not fall under that definition, the plaintiff argued they could utilize the cash method for all farm supplies that were consumed within a year.

The Tax Court agreed with the plaintiff and held that the plaintiff's expenses for field packing materials were fully deductible in the year of purchase. The court noted that the farm syndicate rules were aimed at abusive taxpayers (i.e., "farming syndicates" as that term is defined) and to certain especially abused expenses (i.e., feed, seed, fertilizer, or other similar farm supplies). Those situations were not present under the facts of the case.

The Tax Court also viewed feed, seed, and fertilizer as evoking a class of expenses associated with the growing of crops or the raising of livestock. The field packing materials were neither, the court reasoned, which would appear to place them outside the reach of the 50% test and the farm syndicate rule. Thus, the court agreed with the IRS on this point: Because the named items in the statutory list (feed, seed, and fertilizer) are used directly in production activities, the field packaging materials were not "similar" to those items and were, therefore, outside the scope of IRC §464.

The court then proceeded to analyze the issue under the general rules for supplies (i.e., those supplies that are not "farm supplies") contained in Treas. Reg. §1.162-3. That regulation was amended by TD 9636 (the tangible property regulations) effective for tax years beginning after 2013. However, under the version in effect for the tax years at issue, the court held that the supplies were not limited to deductibility in the year consumed because the taxpayer deducted them when paid. According to the court, Treas. Reg. §1.162-3 merely prevents a double deduction, once in the year paid and once in the year consumed, when it states: "provided that the costs of such materials and supplies have not been deducted … for any previous year." Thus, the plaintiff was allowed to deduct the supplies when purchased, even though it accounted for the supplies not consumed by deferring the expense on its financial statements.

8. *Agro-Jal Farming Enterprises, Inc., et al. v. Comm'r,* 145 TC No. 5 (Jul. 30, 2015).

By determining the amount to report as a deferred expense on the balance sheet, the plaintiff had determined a physical inventory, meaning that the supplies were nonincidental. That is a distinction made by the tangible property regulations for tax years beginning after 2013. However, because the years at issue predated the effective date of the revisions made by the tangible property regulations, the Tax Court did not address the distinction between incidental and nonincidental materials and supplies.

A different and more specific regulation, Treas. Reg. §1.162-12(a), applies to agriculture. This regulation provides that, "A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming."[9] The court did not address Treas. Reg. §1.162-12(a) or mention it because it was not necessary. Because the IRS based its arguments solely on Treas. Reg. §1.162-3, the court kept its focus there. The court determined that Treas. Reg. §1.162-3 did not require capitalization because the amounts for the field packing materials were properly claimed in an earlier year.

Summary

Farmers are specifically allowed to deduct amounts actually expended that are attributable to items used in conducting their farming business. This general principle is only limited if other specific Code provisions provide otherwise (e.g., IRC §263A for the uniform capitalization rules, IRC §464 for the 50% rule, IRC §175 for soil and water conservation expenditures, etc.). In addition, Treas. Reg. §1.162-12(a) was not impacted in any manner by the tangible property regulations, and it remains the authority for farmers to deduct "all amounts actually expended in the carrying on of the business of farming." In any event, however, it is important that farmers pay close attention to meeting the requirements for deducting prepaid expenses given the close scrutiny the IRS gives to such transactions.

TAX ISSUES ASSOCIATED WITH EASEMENT PAYMENTS

OVERVIEW

Rural landowners often receive payment from utility companies, oil pipeline companies, wind energy companies, and others for rights-of-way or easements over their property. The rights acquired might include the right to install pipeline, aerogenerators and associated access roads, electric lines, and similar access rights. Payments may also be received for the placement of a "negative" easement on the property so that that landowner is restricted from utilizing their property in a manner that might decrease an adjacent landowner's property value.

The receipt of easement payments raises several tax issues. The payments may trigger income realization/recognition or could be offset partially or completely by the recipient's income tax basis in the land that the easement impacts.[10] A sale of only part of the land could be involved or a separate payment for crop damage could be made.

9. The regulation goes on to specifically allow a deduction for "ordinary tools of short life or small cost," which includes hand tools, shovels, rakes, etc.

10. For a general and brief discussion of the issue, see IRS Pub. 225, *Farmer's Tax Guide*, p. 17 (2014).

NATURE OF THE TRANSACTION

The grant of a right-of-way often involves a **perpetual easement** that "runs with the land" and is recorded with the title to the land. This binds the current and subsequent property owners subject to the grant. If a perpetual easement is conveyed and the grantor **does not** retain beneficial rights, the transaction involves a **sale** of the underlying tract.[11] However, in many situations, the landowner retains beneficial rights to use the easement property. For example, a landowner may grant an easement to a pipeline company to bury a pipe, but retain the right to plant crops on the surface of the easement property as long as the use does not interfere with the easement. In a situation involving retained rights, the transaction involves the sale of an easement rather than a sale of the underlying tract.

Caution. Sometimes the parties to a transaction may believe that a sale of an easement is involved, and the transaction may be described in that manner. However, the transaction may, in reality, be structured as a lease. If the transaction is a lease, sale treatment is not possible and ordinary income results without an ability to offset the income by the affected property's basis.

EASEMENT PAYMENTS

Permanent Easements

The grant of a limited easement is treated as the sale of a **portion** of the rights in the land impacted by the easement, with the proceeds first applied to reduce the affected land's basis.[12]

Note. Generally, if the grant of an easement deprives the taxpayer of practically all of the beneficial interest in the land except for the retention of mere legal title, the transaction is considered a sale of the land that the easement covers. In such cases, gain or loss is computed in the same manner as a sale of the land itself under IRC §§1221 or 1231.[13]

When an easement is granted over a **specific portion** of the landowner's property, only the land's basis that is allocable to that portion is reduced by the amount received for the grant of the easement.[14] Any excess amount received is treated as capital gain.[15]

Treas. Reg. §1.61-6(a) follows this principle.

> *When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of.*[16]

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11. Rev. Rul. 72-255, 1972-1 CB 221; *Fasken v. Comm'r,* 71 TC 650 (1979).
12. See Rev. Rul. 54-575, 1954-2 CB 145; Rev. Rul. 59-121, 1959-1 CB 212.
13. Ibid.
14. See, e.g., Rev. Rul. 59-121, 1959-1 CB 212.
15. Ibid.
16. See also Rev. Rul. 72-255, 1972-1 CB 221.

The regulation presents two tax issues associated with allocating the landowner's income tax basis in the property.

1. The allocation of basis between the portion of the property that is subject to the easement and the balance of the property that is not subject to the easement[17]
2. The allocation of basis between the rights created by the easement and the balance of the rights in the property

Note. Under the regulation, allocation of basis does **not** require proration based on acreage of the entire tract. Instead, basis allocation is "equitably apportioned." For example, if the land subject to the easement is adjacent to a road, it is possible to allocate a greater portion of the basis per acre to the property subject to the easement.[18] Allocation is most often based on fair market value (FMV) but can also be based on assessed value at the time of the acquisition.[19]

Based on the regulation, it is clear that a taxpayer cannot compare the entire basis in the property from which an easement is acquired with the sale price of the easement unless the entire property is truly impacted by the easement. For example, in *Iske v. Comm'r,*[20] the taxpayer sold easements during condemnation proceedings initiated by a utility to acquire right-of-way easements across land the taxpayer owned. The taxpayer did not include the condemnation award in gross income on the tax return for that year because, as the taxpayer argued, he did not receive a taxable gain on the sale of the easements. However, the court disagreed with the taxpayer's position. The court reasoned that Treas. Reg. §1.61-6(a) required the taxpayer to apportion his basis in the property between the land sold and the land retained. The taxpayer could not use his entire basis in the two parcels involved to offset the amount he received for the easements. **The court found it crucial that the taxpayer did not provide any evidence that a portion of his basis could not be allocated to the property that the easement affected.**

Example 1. Garrulous Energy Company paid $4,000 for an easement along the eastern boundary of Marcia Megawatt's farm. The easement is for the construction of an access road to the location on Marcia's farm where an aerogenerator will be erected. The easement covers approximately five acres of Marcia's 160-acre farm.

Marcia has an income tax basis of $750 per acre in her farmland. For purposes of reporting gain from the $4,000 easement payment, Marcia can offset the $4,000 payment by the $3,750 income tax basis that is allocable to the five acres that the easement impacts ($750 per acre basis × 5 acres). Thus, Marcia must only report $250 of gain ($4,000 − $3,750) from the sale of the easement.[21]

Note. Easement contracts usually describe the exact area of the property affected by the easement. From the legal description, the square footage of that area can be determined. Basis can then be computed per acre. One acre equals 43,560 square feet.

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17. If the easement affects only a specific portion of the tract, only the basis allocable to the affected portion is reduced by the price received from the easement. Rev. Rul. 68-291, 1968-1 CB 351.
18. See, e.g., *Vaira v. Comm'r,* 52 TC 986 (1969); Treas. Reg. §1.61-6(a).
19. *Medlin v. Comm'r,* TC Memo 2003-224 (Jul. 29, 2003).
20. *Iske v. Comm'r,* TC Memo 1980-61 (Mar. 5, 1980).
21. The gain is IRC §1231 gain. For further guidance on the calculation technique utilized in the example, see Rev. Rul. 68-291, 1968-1 CB 351.

If the easement impacts the taxpayer's entire property (which is uncommon), the amount received for the easement reduces the taxpayer's basis in the entire property for purposes of computing taxable gain.

Observation. A taxpayer who takes the position that the grant of an easement impacts their entire property bears the burden of proving that position. The IRS will likely challenge it. The ultimate outcome is heavily fact-dependent.

Example 2. Vern sells multiple easements to a wind energy company for access to a major aerogenerator project on his ranch. The easements cover 550 acres (out of 640 total acres that Vern owns) and bisect Vern's property. The wind energy company constructed fences on each side of every easement and installed gates in the fences so that Vern could move his livestock through the easements. Because of these particular facts, Vern might successfully argue for a reduction of basis in his entire 640 acres. Vern must establish that the easements affect his use of the entire 640 acres, rather than just the 550 acres covered by the easements.[22]

Caution. If it is not possible to allocate the basis of the entire property between the interest that is sold and the interest that is retained, then the easement proceeds can be used to reduce the basis in the entire property affected.[23] However, the IRS is likely to challenge an allocation of basis across the entire property. A favorable IRS letter ruling or court decision in which the court finds it impracticable or impossible to determine the specific portion of the property impacted by the easement may be necessary.[24]

Income tax basis must also be allocated between the rights that the taxpayer retains and the easement rights that are sold. For purposes of this basis allocation, the general rule is that the allocation of basis in the property must be allocated between the interest sold and the interest retained in the proportions that their respective FMVs bear to the FMV of the entire property.[25]

It may be possible to determine the actual portion of a client's property that is impacted by an easement project by examining the terms of the particular easement. Many easement agreements prohibit the landowner from building anything on the property that would interfere with the maintenance or operation of the easement holder's property. That could give the landowner a reasonable argument that the easement affects **all** of the landowner's property. If there is sufficient basis in the land to absorb the easement payment, the landowner will not have any gain to report.

22. This example is based on the facts in *Bledsoe v. U.S.,* 67-2 TC 9581 (1967). See also *Conway v. U.S.,* 73-1 TC 9318 (1973).

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

24. See, e.g., *Gilbertz v. U.S.,* 808 F.2d 1374 (10th Cir. 1987). Also see *Fasken v. Comm'r,* 71 TC 650 (1979). Taxpayer was granted four easements for utility lines. The court required the consideration received for the easements applied against the portion of the adjusted basis for the ranch allocable to the acreage affected by each particular easement instead of applying the consideration against the ranch's entire basis. The taxpayer was unable to show that usefulness of the ranch was affected by easements or that it was not possible to allocate basis to the area actually affected by each easement.

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

Example 3. Tom owns an 80-acre tract of farmland that he bought in 1983 for $40,000. It is entirely pastureland, and no improvements were made. Tom was approached by a wind energy company to construct three aerogenerators on his property. The company is willing to pay Tom $25,000 for an easement. The easement terms prevent Tom from building anything on this property that would obstruct the company's access to the aerogenerators or that would block the wind. Tom should be able to reduce the basis in his entire tract by the amount of the easement payment. This reduces his basis to $15,000 ($40,000 − $25,000), and Tom has no gain to report.

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

Caution. Tom's logic in **Example 3** may be challenged by the IRS. Many commercial aerogenerators are placed on 300–350 foot towers. If this is the case, the tips of the blades might reach as high as 525 feet. In that scenario, it might be illogical for Tom to argue that his future construction of a machine shed, for example, could possibly block the wind to the three aerogenerators.

If Tom wants to erect a structure on his farm, he should ask the wind energy company if the structure violates the standard "no interference" clause. In the vast majority of scenarios, permission is granted to erect the structure.

The following case law supports the argument that an easement can affect **all** of a taxpayer's property and, hence, allows the taxpayer's entire basis in the property to be applied against the easement payment.

- *Bledsoe v. U.S.*[26] — The landowner sold nine perpetual easements to the U.S. Army Corps of Engineers to allow road access to a dam. The easements covered only 47.3 acres, but the court allowed the landowner to reduce the basis of the entire 454.54.acres because the easements restricted his use of the property. The easements varied in width from 100 to 400 feet and bisected his ranch. The easement holder then constructed a fence along the road on both sides and built gates in the fences so that the taxpayer could move his cattle across the easements. **Contrary** to the general rule, the court held that the easements were not sales, and that the taxpayer was entitled to apply the easement proceeds against the property's basis.
- *Conway v. U.S.*[27] — The landowner sold a right-of-way across his farm to a coal company, retaining ingress and egress rights and a reversion of the right-of-way upon abandonment. The court allowed the landowner to offset the payment received for the grant by the landowner's basis in the entire property.
- *Inaja Land Company, Ltd. v. Comm'r*[28] — The City of Los Angeles paid the landowner $50,000 for a perpetual easement that allowed the city to flood the land when it diverted water into a river that flowed through the land. The easement did not cover the entire tract, but because it affected the use of the entire tract, the court allowed the payment for the easement to reduce the basis of the entire tract. The court specifically noted that apportionment was impossible.

26. *Bledsoe v. U.S.,* 67-2 TC 9581 (1967).
27. *Conway v. U.S.,* 73-1 TC 9318 (1973).
28. *Inaja Land Company, Ltd. v. Comm'r*, 9 TC 727 (1947).

Severance Damage Payments

An easement can bisect a landowner's property in such a manner that the property not subject to the easement can no longer be put to its highest and best use. This is more likely with commercial property and agricultural land that has the potential to be developed. Severance damages may be paid to compensate the landowner for the resulting lower value of the unaffected property. For example, in *Foster, et al. v. Comm'r*,[29] the amount received from a utility company for a right-of-way easement for high voltage lines was applied against the taxpayer's basis in the entire property as severance damages. The court determined that an additional amount paid for a "sway" easement also reduced the basis in the entire property. The court found that both easements were integrally related and impacted the entire property.

If severance damages exceed the landowner's basis in the property not subject to the easement, gain is recognized.[30]

> **Note.** Under IRC §1033, the landowner may be able to defer gain resulting from the payment of severance damages by using the severance damages to restore the property affected by the easement or by investing the damages in a timely manner in other qualified property.[31] The landowner is not required to apply the severance damages to the portion of the property subject to the easement. Additionally, if the easement affects the remainder of the property such that the pre-easement use of the property is not possible, the sale of the remainder of the property and use of the sale proceeds (plus the severance damages) to acquire other qualified property can be structured as a deferral transaction under IRC §1033.[32]

Temporary Easement Payments

Some easements may involve an additional temporary easement to allow the holder to have space for access, equipment, and material storage while conducting construction activities on the easement property. A separate designation for a **temporary easement** for these purposes generates **rental income** for allocated amounts. As one alternative, it may be advisable to include the temporary space in the perpetual easement, which is then reduced after an established period. Under this approach, the payment attributable to the temporary easement can be applied to reduce the basis in the tract subject to the permanent easement.[33] A second alternative, classifying any payments for a temporary easement as damage payments, may be possible, depending on the facts.

Damage Payments

Upfront payments to a landowner for actual, current damage to the property caused by easement construction activities may be offset by basis in the affected property.[34] Payments for property damage caused by environmental contamination and/or soil compaction are examples of this type of payment. A payment for damage to growing crops, however, is treated as a sale of the crop, which is reported by an operating farmer on line 2 of Schedule F, *Profit or Loss From Farming.* If the landowner is a crop share landlord, the payments are reported on line 1 of Form 4835, *Farm Rental Income and Expenses.*

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29. *Foster, et al. v. Comm'r*, 80 TC 34 (1983), *aff'd and vacated*, 756 F.2d 1430 (9th Cir. 1985).
30. Rev. Rul. 68-37, 1968-1 CB 359.
31. Rev. Rul. 83-49, 1983-1 CB 191.
32. Rev. Rul. 59-361, 1959-2 CB 183.
33. Rev. Rul. 73-161, 1973-1 CB 366.
34. See, e.g., FSA 200228005 (Mar. 29, 2002). Settlement proceeds received for land contamination and impact on water rights are treated as a nontaxable return of capital to the extent of basis.

Any payment for **future** property damage is generally treated as rent.

Note. Most easements contain release language covering loss of rents, damage to the surface, damage to fences, water impoundments, vegetation, and crops. The release language generally applies to future damages. In the IRS's view, any associated payment constitutes rent that cannot be offset by basis. Clearly, careful drafting of the easement that distinguishes between upfront damage payments and covenants to compensate for future damages is essential. It is unclear whether courts would assume that construction activities necessarily result in damages. In any event, maintaining relevant documentation is key.

Lease Payments

A right of use that is not an easement generates ordinary income to the landowner and is, potentially, net investment income subject to the 3.8% net investment income tax.[35] Thus, transactions that are a lease or a license generate rental income with no basis offset. For example, when a landowner grants surface rights for oil and gas exploration, the transaction is most likely a lease. Easements for pipelines, roads, surface sites, and similar interests that are for a definite term of years are leases.[36] Likewise, if the easement is for "as long as oil and gas is produced in paying quantities," it is a lease.[37]

Note. When a landowner retains reversionary rights, sale treatment may not result unless the retained rights are contingent. However, a transaction involving a contingent reversion in case the easement is not used or abandoned constitutes a sale of an easement.[38] Likewise, if reversion is triggered, for example, on the failure to maintain insurance coverage, the filing of bankruptcy, assignments for the benefit of creditors, or an unauthorized assignment or like events, easement status is maintained.

A lease is characterized by periodic payments. A lease is also indicated when failure to make a payment triggers default procedures and potential forfeiture.

Lease payments are not subject to self-employment (SE) tax in the hands of the recipient regardless of the landowner's participation in the activity.[39] Accordingly, the annual lease payment income is reported on Schedule E, *Supplemental Income and Loss,* with the landowner likely having few or no deductible rental expenses.

Negative Easement Payments

A landowner may make a payment to an adjacent or nearby landowner to acquire a **negative easement** over that other landowner's tract. A negative easement is a restriction placed on the tract to prevent the owner from specified uses of the tract that might diminish the value of the payor's land. For instance, a landowner may fear that their property would lose market value if a pipeline, high-power transmission line, or aerogenerator were placed on adjacent property. Thus, the landowner might seek a negative easement over the adjacent property to prevent that landowner from granting an easement to a utility company for that type of activity on the adjacent property.

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35. IRC §1411.

36. *Gilbertz v. U.S.*, 808 F.2d 1374 (10th Cir. 1987).

37. *Vest v. Comm'r*, 481 F.2d 238 (5th Cir. 1973); *Estate of Reinke v. Comm'r*, TC Memo 1993-197 (May 4, 1993); *Wineberg v. Comm'r*, TC Memo 1961-336 (Dec. 14, 1961), *aff'd,* 326 F.2d 157 (9th Cir. 1963).

38. Ibid.

39. IRC §1402(a)(1).

In recent field attorney legal advice, the IRS decided that a negative easement payment is rental income in the hands of the recipient.[40] It is not income derived from the taxpayer's trade or business. The facts of the ruling involved a taxpayer that was a C corporation. The C corporation owned property adjacent to a plant owned by another corporation. The adjacent corporation wanted to protect itself from potential liability as a result of activities on the C corporation's property. Accordingly, it paid the C corporation for a negative easement over a strip of land closest to its border to act as a buffer. The agreement between the parties for the recorded negative easement called for annual payments for a term of years. The C corporation wanted to characterize the payments as business income to avoid triggering an additional 20% tax under the personal holding company (PHC) rules of IRC §§541-547.

Note. A C corporation is a PHC under IRC §542(a)(1) if more than 50% of the corporate stock is held, either directly or indirectly, by five or fewer individuals, **and** the corporation derives at least 60% of its adjusted ordinary gross income (AOGI) from passive investment sources. Rental income is included in AOGI unless adjusted rental income is:

- At least 50% of AOGI, and
- Dividends for the tax year equal or exceed the amount (if any) by which the corporation's nonrent PHC income for that year exceeds 10% of its ordinary gross income.

In other words, if the mixture of rental income and other passive income sources exceed the 10% threshold and the rental income exceeds the 50% threshold, the PHC tax could be triggered.

The IRS noted that there was no direct authority as to how to treat negative easement payments for PHC purposes. However, the IRS did find cases involving conservation reserve program (CRP) payments to landowners and the SE tax treatment of those payments to be relevant. In *Morehouse v. Comm'r*,[41] the 8th Circuit reversed the Tax Court and held that CRP payments were rental payments (for SE tax purposes) because they were compensation to the landowner for the government's possession and use of the landowner's property. The court determined that the CRP payments were synonymous with easement payments and were not subject to SE tax in the hands of a nonfarmer.

In the Field Service Advice (FSA), the IRS defined rent as "amounts received for the use of, or right to use, property of the corporation." The IRS cited *Morehouse* for the proposition that CRP payments are "rents" that are paid to the landowner for the government's **use** of the property. In the FSA, the IRS determined that the negative easement payments were made to prevent the C corporation from using its property in a way that would diminish the value of the other corporation's property. This, the IRS found, was a "use" of the C corporation's property.[42] The IRS believed that *Morehouse* supported its FSA position because Mr. Morehouse was a nonfarmer and the government was using his property for the government's own purposes.

Note. Although the FSA was not the result that the taxpayer desired (because of the complications with the PHC), the FSA does hold that negative easement payments are "rents" that are not subject to SE tax. However, the rents would be treated similarly to other passive sources of income and could be subjected to the 3.8% net investment income tax under IRC §1411. In addition, the IRS's position taken in the FSA could be applied to situations involving the government's use of a taxpayer's property to enhance wildlife and conservation.

40. FSA 20152102F (Feb. 25, 2015).

41. *Morehouse v. Comm'r*, 769 F.3d 616 (8th Cir. 2014), *rev'g* 140 TC 350 (2013).

42. The IRS stated, "We believe this is using/employing the property for the accomplishment of a business purpose, i.e., to avoid/limit liability."

Reporting the Transaction

The party that acquires the easement must report the transaction using Form 1099-S, *Proceeds From Real Estate Transactions*.[43] Rental payments and damage payments are reported on Form 1099-MISC, *Miscellaneous Income*.[44]

EMINENT DOMAIN

Proposed easement acquisitions can be contentious for many landowners. Often, landowners may not willingly grant a pipeline company or a wind energy company the right to use the landowners' property. In those situations, eminent domain procedures under state law may be invoked. These procedures involve a property's condemnation. The power of eminent domain is the right of the state government (it is called the "taking power" for the federal government) to acquire private property for public use, subject to the constitutional requirement that "just compensation" be paid. Although eminent domain is a power of the government, developers of pipelines and certain other types of energy companies are often delegated the authority to condemn private property. The condemnation award (the constitutionally required "just compensation") paid is treated as a sale for tax purposes.[45]

> **Note.** The condemnation award is tied to the "taken" property's FMV. As is the case with negotiated easements, the landowner may also recover amounts for a temporary easement, severance damages, crop damage payments, and for the relocation of fixtures and personal property. Interest on these amounts may also be recovered. These additional amounts must be authorized by state law. Payments to relocate fixtures and personal property are typically set at the lesser of the property's FMV or the actual cost to relocate the property. If any amount paid is allocated to IRC §§1245 or 1250 property, recapture could be triggered.

The IRS's view is that a condemnation award represents the sales price of the property taken, and the Tax Court generally agrees.[46] However, if the condemnation award clearly exceeds the FMV of the property taken, a court may entertain arguments about the various components of the award.[47] Thus, it is important for a landowner to preserve any evidence that might support allocating the award to various types of damages.

> **Observation.** In the event that a personal residence is part of the condemnation, the taxable amount of the award is decreased by the gain excluded under IRC §121(d)(5)(B).

Deferral of Gain

Although a condemnation award is treated as a sale for tax purposes, IRC §1033 (involuntary conversion rules) allows a recipient to elect to defer gain realized from a condemnation (and sales made under threat of condemnation) by reinvesting the proceeds in qualifying property.

> **Note.** A sale made under threat of condemnation can occur, for example, when a landowner sells easements over their property to a company that is threatening to condemn the easement unless the landowner grants it.[48]

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43. Instructions for Form 1099-S.

44. Instructions for Form 1099-MISC.

45. See, e.g., *Hawaiian Gas Products, Ltd., v. Comm'r*, 126 F.2d 4 (9th Cir. 1942).

46. Rev. Rul. 59-173, 1959-1 CB 201; *Asjes v. Comm'r*, 74 TC 1005 (1980).

47. See, e.g., *Conran v. U.S.*, 322 F.Supp. 1055 (E.D. Mo. 1971).

48. In these situations, one issue is whether the company actually has the power of condemnation. See, e.g., *Texas Rice Land Partners, Ltd. v. Denbury Green Pipeline-Texas, LLC,* 363 S.W.3d 192 (Tex. 2012). An operator of a carbon dioxide pipeline secured easements under the threat of condemnation when the operator was not a common carrier having such power at the time of the acquisitions. See also Rev. Rul. 74-8, 1974-1 CB 200. A sale made under the threat of condemnation was an involuntary conversion when the utility at issue did not actually possess the power of eminent domain, even though the utility could acquire it.

The election to defer gain under IRC §1033 is made by simply not reporting the condemnation gain realized on the return for the tax year the award is received.[49] However, in the year in which the gain is realized, the regulations require the taxpayer to disclose the details concerning the replacement property.[50]

Example 4. Ole McDonald received a $200,000 condemnation award on a tract of farmland from Earth, Wind, & Fire Inc. on December 1, 2014. A Form 1099-S is issued to Mr. McDonald. He plans to purchase qualifying replacement property within three years. The transaction is reported on Form 4797 as follows.

Form **4797**
Department of the Treasury
Internal Revenue Service

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))
▶ Attach to your tax return.
▶ Information about Form 4797 and its separate instructions is at *www.irs.gov/form4797.*

OMB No. 1545-0184
2014
Attachment Sequence No. 27

Name(s) shown on return	Identifying number
Ole McDonald	123-45-6789

1	Enter the gross proceeds from sales or exchanges reported to you for 2014 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)	1	200,000

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
Land Condemnation	07/01/99	12/01/14	200,000		200,000	0

Mr. McDonald attaches the following election to his return:

An election is made under IRC § 1033 to defer gain on condemnation award received. The taxpayer intends to replace the property within the replacement period.

Note. The purpose of showing the receipt of the funds on Form 4797 is to reduce the likelihood of receiving a CP-2000 (underreported income) notice.

49. A partnership makes the election at the partnership level. *Demirjian v. Comm'r,* 457 F.2d 1 (1972).

50. Treas. Reg. §1.1033(a)-2(c)(2). If the replacement property has not been acquired at the time the return is due and, thus, the details concerning the replacement property are not available to disclose, the election to defer the gain is deemed to have been made if no gain is reported.

For real property acquired by condemnation or threat of condemnation, the gain realized can be deferred if the proceeds are reinvested in like-kind property[51] **within three years after the close of the first tax year in which the taxpayer realizes any part of the gain** (i.e., in the first year in which the proceeds exceed the taxpayer's basis in the affected property) on the involuntary conversion.[52] More specifically, the replacement period begins on the earlier of the date of disposition or the date that condemnation is threatened, and ends three years after the close of the first tax year in which any part of the gain is realized.[53]

> **Note.** Detailed information concerning the condemnation should be disclosed with the return for any year in which gain from the transaction is realized. Likewise, information concerning the replacement property should be disclosed for the tax year (or years) in which the replacement property is acquired. Form 4797 is used to report an involuntary conversion of property used in the taxpayer's trade or business (or capital assets held for business or profit). Form 8949, *Sales and Other Dispositions of Capital Assets,* is used to report gain from capital assets not held for business or profit.

If the landowner uses severance damages to restore property that is retained or to reinvest in the replacement property, the severance damages may also qualify for deferral under IRC §1033. Likewise, if the condemnation makes the use of the remainder of the landowner's land impractical such that the landowner sells the remaining property, the sale proceeds may also qualify for deferral under IRC §1033.

If the amount realized from the condemnation is less than the cost of the replacement property, the taxpayer's basis in the replacement property is the cost of the replacement property less any unrecognized gain. If the amount realized from the condemnation exceeds the cost of the replacement property, the landowner has gain recognition to the extent of the excess of the amount of the gain realized over cost, and the basis in the replacement property is cost less any unrecognized gain.[54]

The IRS ruled that basis is allocated between land and improvements,[55] even if the condemnation award was only for land. IRC §1223 establishes the holding period for the replacement property, and the IRS ruled that the holding period of the condemned property is attributed proportionally to the property acquired.[56]

> **Note.** Deferral under IRC §1033 may not result in the deferral of recapture income under IRC §§1245 and/or 1250. This is particularly the case if multiple classes of property are condemned because the regulations require the amount realized from the condemnation to be allocated between the various classes.

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51. Like-kind property is property that is similar or related in service or use. IRC §1033(a). But, the "like-kind" rules for real property set forth in IRC §1031 apply. IRC §1033(g); Treas. Reg. §1.1031(a)-1(b). This is a more relaxed standard than applies for personal property trades.

52. The replacement period is three years if the condemned property is held for productive use in the taxpayer's trade or business or for investment. When an IRC §1033 election is made, the IRS has three years from the date it receives notification of replacement or failure to replace in which to assess a deficiency.

53. Constructive receipt rules apply. Also, it is important to ensure that the transaction for the replacement property is finalized within the replacement period. See, e.g., *Fort Hamilton Manor v. Comm'r,* 445 F.2d 879 (2d Cir. 1971). Upon request, the IRS may extend the replacement period for good cause.

54. IRC §1033(b)(2).

55. Rev. Rul. 79-402, 1979-2 CB 297.

56. Rev. Rul. 81-285, 1981-1 CB 173.

Expenses

Expenses that the landowner incurs during the condemnation process are treated as capital expenditures. Thus, they are added to the landowner's basis in the property subject to the easement. This has the effect of reducing the gain (or increasing the loss) upon condemnation. Expenses that are made to substantiate and recover severance damages are capitalized as part of the basis of the property that is not condemned.

ESTATE TAX IMPLICATIONS

Long-term leases (known as a "leased-fee interest")[57] can also impact the federal estate value of the land subject to the lease. Property is valued for estate tax purposes at its FMV as of the date of the decedent's death. FMV is determined under a willing-buyer, willing-seller test.[58] The Tax Court has held that leased-fee interests must be taken into account for their impact on the value of the real estate for estate tax purposes.[59] In *Estate of Mitchell v. Comm'r,*[60] the decedent's estate included various residential rental properties with one of the properties having an unexpired lease at the time of the decedent's death. Under the terms of the lease, the tenant could renew the lease for about 20 years after the date of the decedent's death. The Tax Court valued the property subject to the lease by adding the value of the landlord's reversionary interest in the property to the adjusted value of the lease payments that were owed to the decedent. The result was an enhancement to the property's value for estate tax purposes.

> **Observation.** A long-term agreement signed shortly before death likely has little impact on the subject property's estate tax value, because the agreement (particularly for mineral and wind energy development) has an initial development/prospecting phase that runs for several years before the primary phase of the easement. Thus, if the decedent dies during the prospecting phase, uncertainty remains as to whether production will ever occur on the premises. Consequently, there should be no valuation enhancement. However, if death occurs after the development phase and activity commenced on the leased premises, the IRS could argue for a valuation enhancement.

A related estate tax concern involves special-use valuation.[61] One court held that the grant of an easement was a disposition of a property interest under federal law that resulted in recapture tax being triggered under IRC §2032A(c)(1).[62]

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57. In *Marks v. Comm'r,* TC Memo 1985-179 (Apr. 10, 1985), the court said that a leased-fee interest exists when the "owner of commercial or income-producing property has the right to receive the actual contract rent that the property is generating over the remaining terms of the outstanding leases on the property…"

58. Rev. Rul. 59-60, 1959-1 CB 237; Treas. Reg. §20.2031-1(b).

59. *Estate of Mitchell v. Comm'r,* TC Memo. 2011-94 (Apr. 28, 2011).

60. Ibid.

61. IRC §2032A.

62. *Estate of Gibbs v. U.S.,* 161 F.3d 242 (3d Cir. 1998). At issue was the grant of an agriculture preservation easement that ensured that the land subject to the easement would not be developed.

CRP PAYMENTS AS SELF-EMPLOYMENT INCOME

The Conservation Reserve Program (CRP), originally enacted in 1985, is an agricultural program administered by the U.S. Department of Agriculture (USDA). Under the CRP, the program participant agrees to remove land from active farming, implement a conservation plan, and seed the tract to permanent grass or other vegetative cover to prevent erosion and improve soil and water resources. The USDA, in exchange, generally shares the initial cost of the conservation measures and makes an annual rental payment (reported on a Form 1099 if $600 or more) to the landowner.

Note. Since **2006,** the IRS has asserted that, regardless of whether the taxpayer is an operating farmer or an inactive landlord, CRP payments are subject to self-employment (SE) tax. Effective for tax years beginning after 2007, Congress changed the applicable statute such that the IRS's position does not apply to **any** taxpayer who receives social security benefits.

The discussion here sets forth a general history of the SE tax treatment of analogous government payments, how the courts have ruled on the SE taxability of CRP payments, the 2008 statutory amendment, and the most recent case developments on the SE taxability of CRP rents. Guidance is provided as to how to report CRP payments on a tax return.

HISTORY OF SE TAX TREATMENT OF GOVERNMENT PAYMENTS

In **1965,** the IRS ruled that grain storage fees paid under a price support loan program of the Commodity Credit Corporation (CCC) are SE income if they are paid to an active farm operator. However, such fees are excludable from SE income if they are paid to a taxpayer who did not materially participate in the farming operation.[63] That ruling followed, and is consistent with another ruling that the IRS released in 1960. In the 1960 ruling, the IRS took the position that payments received for acres idled under the Soil Bank program were SE income "if he operates his farm personally … or … if his farm is operated by others and he participates materially in the production of commodities…"[64]

When the CRP was created as part of the 1985 Farm Bill (the CRP has been termed the "son of Soil Bank"), the IRS maintained that its rulings from the 1960s applied and that CRP rents were not subject to SE tax in the hands of a nonfarmer. CRP rents, according to the IRS, would only be subject to SE tax if the recipient was a farmer. For example, in *Ray v. Comm'r,*[65] an active farmer who received CRP income was required to pay SE tax on the CRP rents because the farmer was found to already be in the business of farming and the CRP had a direct relationship **(nexus)** to the farming business. Although the farmer was required to care for and conserve the acreage, he was not permitted to farm or graze the land.

Note. The Tax Court's *Ray* decision reinforced the conclusion that a farmer actively involved in the business of farming who receives CRP income for **not** farming the acreage is still subject to SE tax on the CRP rents.

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

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

65. *Ray v. Comm'r,* TC Memo 1996-436 (Sep. 25, 1996).

In **1998,** the Tax Court held that CRP payments in the hands of an active farmer were not subject to SE tax. In *Wuebker v. Comm'r,* an active farmer received about $18,000 of CRP payments in 1992 and 1993. The payments were reported on Schedule E, *Supplemental Income and Loss,* as land rents. At the same time, the taxpayer reported other farming activity on Schedule F, *Profit or Loss From Farming,* which was subject to SE tax. The IRS assessed SE tax on the CRP income. However, the Tax Court concluded that the CRP payments were rental income and, accordingly, exempt from SE tax under IRC §1402(a)(1).[66] The Tax Court noted that both the federal legislation authorizing the CRP program and the CRP contractual terms described the payments as rental income.

Further, the court noted that the farmer's service requirements with respect to the land (implementing a conservation plan and establishing ground cover) were incidental, particularly after the first year. Thus, the court concluded that the CRP payments represented rental for the use of land rather than payment for services and excluded the payments from SE income as real estate rentals. Having determined that CRP income qualifies as real estate rental under IRC §1402(a)(1), the Tax Court pointed out that, based on Treas. Reg. §1.1402(a)-4(d), the CRP income is exempt from SE tax even if the payments are associated with a taxpayer's active farming operation.[67]

Note. The Tax Court distinguished its findings in *Wuebker* from its earlier opinion in *Ray*, noting that the issue of equating the CRP payments with rental income was not raised by the taxpayer in that case. The *Ray* case focused exclusively on the nexus between the CRP payments and the taxpayer's farming business, but the Tax Court stated that its determination of CRP income as rental income made that issue moot.

The IRS appealed the Tax Court's decision, and the 6th Circuit reversed in a split decision.[68] In reaching its decision, the 6th Circuit noted that the taxpayer was actively engaged in farming prior to and during the term of the CRP contract. Furthermore, the CRP payments were "in connection with" and had a "direct nexus to" the taxpayer's ongoing farming business. The 6th Circuit concluded that the key to the SE tax analysis was the substance, rather than the form, of the transaction. Even though the USDA program labeled the CRP payments as rent, this alone was not determinative of the tax issue, given the CRP income's connection to the active farm business.

The 6th Circuit also differed with the Tax Court on the basic issue of whether CRP income was rent. Noting that rent is defined as payment "for the use or occupancy of property," the 6th Circuit observed that the USDA (the payor of the CRP revenue) was not using or occupying the farmland. The court noted that the Wuebkers continued to have control over and access to their property, despite the CRP restrictions on the agricultural use of the land.

Observation. This split between the Tax Court and the 6th Circuit appears to be a classic judicial difference in approach. The Tax Court took the more literal interpretation, considering CRP income exempt from SE tax because of its plain equivalence to cash rental income. On the other hand, the 6th Circuit disregarded the rental terminology of the CRP program and considered the revenue a USDA subsidy in lieu of active farming income.

66. *Wuebker v. Comm'r,* 110 TC No. 31 (1998).

67. Treas. Reg. §1.1402(a)-4(d) states that when an individual or partnership is engaged in a business and the income is classifiable in part as real estate rental, only that portion of the income that is not classifiable as real estate rental is subject to SE tax.

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

In late **2006,** the IRS announced a proposed revenue ruling, taking the position that CRP payments are **always** subject to SE tax, whether received by an active farmer or an inactive landlord/investor.[69] The proposed revenue ruling (which was never made final) contained two situations to illustrate its potential holdings.

- In the first situation, an individual actively engaged in the business of farming enrolled a portion of their land in the CRP. The proposed ruling held that the individual would be subject to SE tax on the CRP income.
- In the second situation, individual B, a landowner, ceases all activities related to the business of farming in the year before they enter into a CRP contract. In that subsequent year, B rents out a portion of their land to another farmer and enters into a 10-year CRP contract with respect to the remaining portion of the land. A third party performs the seeding and weed control required under the CRP contract. The proposed ruling held that the individual must treat their CRP rental income as subject to SE tax. This second situation relied on the 6th Circuit's *Wuebker* decision, and focused on the activities required under the CRP contract (tilling, seeding, fertilizing, and weed control).

As a result of a provision included in the 2008 Farm Bill effective for CRP payments for tax years after 2007, individuals receiving benefits under section 202 (retirement) or section 223 (disability) of the Social Security Act are exempt from the payment of SE tax on CRP income.[70] For other taxpayers, no change was made in the SE tax treatment of CRP payments.[71]

> **Note.** This statutory change **clearly exempts** individuals who are collecting retirement or disability benefits from the Social Security Administration from SE tax on CRP income, even though they might be reporting the CRP income on Schedule F due to other active farming activities.[72] This rule applies even if the taxpayer begins receiving social security benefits before reaching full retirement age.

For reporting purposes, the instructions for Schedule SE, *Self-Employment Tax,* state that CRP payments should be included on line 4b of Schedule F or entered on Schedule K-1 (Form 1065), box 20, code Z. If the taxpayer receives social security benefits at the time CRP payments are received, the CRP payments are subtracted on line 1(b) of Schedule SE.[73]

Schedule SE (Form 1040) 2014 — Attachment Sequence No. **17** — Page **2**

Name of person with **self-employment** income (as shown on Form 1040 or Form 1040NR) | Social security number of person with **self-employment** income ▶

Section B—Long Schedule SE

Part I **Self-Employment Tax**

Note. If your only income subject to self-employment tax is **church employee income,** see instructions. Also see instructions for the definition of church employee income.

A If you are a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361, but you had $400 or more of **other** net earnings from self-employment, check here and continue with Part I . . . . ▶ ☐

1a Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A. **Note.** Skip lines 1a and 1b if you use the farm optional method (see instructions) **1a**

b If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code Z **1b** ( )

Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065),

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

70. The provision amended IRC §1402(a)(1).

71. The Committee Report to the 2008 Farm Bill states that "the treatment of conservation reserve payments received by other taxpayers is not changed."

72. Railroad Retirement tier III benefits are not retirement benefits from the Social Security Administration. Taxpayers who receive railroad retirement but not social security benefits are not protected from SE tax.

73. Instructions for Schedule SE.

Based on the court rulings, **the IRS has significant support for its position that an active farmer is subject to SE tax on CRP income.** As a result, many practitioners have taken the conservative approach of reporting CRP income as Schedule F income subject to SE tax for active farmers. The *Ray* case and 6th Circuit's *Wuebker* opinion represent strong authority for treating an active farmer's CRP income as business-related income subject to SE tax.

Some practitioners, particularly those representing clients not within the 6th Circuit (Kentucky, Michigan, Ohio, and Tennessee) have taken a more aggressive approach. These practitioners, on a case-by-case basis, advise active farmers of the controversy and continue to report CRP income as non-SE income based on the Tax Court's *Wuebker* opinion.

For taxpayers who are **not** actively involved in farming (and not receiving social security benefits), the IRS's position that CRP rents are subject to SE tax is much weaker. As noted previously, the IRS had always held that Soil Bank and CRP payments were not subject to SE tax in the hands of a nonfarmer. However, beginning in 2003, the IRS signaled that it changed its longstanding position on the matter. The IRS took the position in a 2003 Chief Counsel Advice Memorandum[74] and in a 2006 IRS notice[75] that a nonfarmer landlord is subject to SE tax on CRP income only. No court has ever supported this IRS position.

CRP and Nonfarmers — The *Morehouse* Litigation

In **2013,** the U.S. Tax Court released its opinion in *Morehouse v. Comm'r.*[76] Mr. Morehouse was a nonfarmer who lived in Texas and worked for the University of Texas. In 1994, he inherited farmland in South Dakota and bought other farmland from his family members. He never personally farmed the land, but he rented it out. In 1997, Mr. Morehouse put the bulk of the property in the CRP while continuing to rent out the non-CRP land. He hired a local farmer to maintain the CRP land consistent with the CRP contract (e.g., plant a cover crop and maintain weed control). In 2003, the petitioner moved to Minnesota, but still never personally engaged in farming activities. Consequently, the petitioner reported his CRP income on Schedule E, where it was not subject to SE tax.

The IRS took the position that the CRP rents were subject to SE tax, based on its 2003 administrative change of position. The Tax Court, in a full Tax Court opinion, agreed.[77] The Tax Court determined the existence of a trade or business, either through the petitioner's personal involvement with the CRP contract[78] or through the local farmer that he hired to maintain the land. The court cited the 6th Circuit's decision in *Wuebker*[79] as controlling even though the taxpayer in that case was an active farmer and Mr. Morehouse had never been engaged in farming. Thus, *Wuebker* was factually distinguishable. However, the court stated that the petitioner was in the business of maintaining "an environmentally friendly farming operation."

> **Note.** Although, as the Tax Court ruled in *Morehouse*, CRP payments may not constitute rents from real estate such that they are exempt from SE tax under IRC §1402(a)(1), that determination has no bearing on the issue of whether the taxpayer is engaged in a trade or business as required by IRC §1402(a). That question can only be answered by examining the facts pertinent to a particular taxpayer. Mere signing of a CRP contract and satisfying the contract terms via an agent is insufficient to answer that question.

74. CCA 200325002 (May 29, 2003).
75. IRS Notice 2006-108, 2006-51 IRB 1118.
76. *Morehouse v. Comm'r,* 140 TC No. 16 (2013).
77. Ibid. Judge Paris did not participate.
78. The court noted that the CRP contract required seeding of a cover crop and maintenance of weed control, that the taxpayer visited the properties on occasion to ensure that the CRP contract requirements were being satisfied, that the taxpayer participated in emergency haying programs and requested cost-sharing payments, and that the taxpayer made the decision as to whether to re-enroll the properties in the CRP upon contract expiration.
79. *Wuebker v. Comm'r,* 205 F.3d 897 (6th Cir. 2000).

The Tax Court's opinion was appealed to the U.S. Court of Appeals for the 8th Circuit. The majority opinion noted that the CRP is the current federal program in a long line of conservation programs and is similar to the old Soil Bank program — even noting that the CRP was referred to as the "Son of Soil Bank."[80] Based on that close tie, the court noted that the IRS, in Rev. Rul. 60-32,[81] said that Soil Bank payments paid to **nonfarmers** were not subject to SE tax, but they were subject to SE tax if they were paid to materially participating farmers. The IRS again restated that position in Rev. Rul. 65-149.[82] The court found those rulings persuasive and binding on the IRS given the similarities between the CRP and the Soil Bank program. **Thus, the court held that "CRP payments made to nonfarmers constitute rentals from real estate for purposes of §1402(a)(1) and are excluded from the self-employment tax."**

> **Note.** The court also pointed out that the IRS issued a proposed revenue ruling in IRS Notice 2006-108[83] and "with little analysis, the proposed revenue ruling concluded CRP payments to nonfarmers were not rentals from real estate and should be treated as income from self-employment." The IRS said in that notice that the proposed revenue ruling would make Rev. Rul. 60-32 obsolete. **However, the IRS never formally adopted the proposed revenue ruling, and the 8th Circuit's decision refused to give it any deference.**

The court distinguished the 6th Circuit's opinion in *Wuebker*[84] on the basis that the taxpayer in *Morehouse* was not a farmer, while the taxpayer in *Wuebker* was an active farmer. On that point, the court noted that the 6th Circuit "neither recognized nor rejected the IRS's position in Rev. Rul. 60-32 that similar payments [i.e., Soil Bank payments] to nonfarmers were not SE income."

The court also viewed the CRP payments that the taxpayer received as being for the use and occupancy of his land, noting that the CRP contract reserves the government's right of entry on the land. The court also found it important that the IRS had represented that if the taxpayer had not fulfilled the contractual requirements, "the USDA could arrange for any needed work to complete 'on his behalf.'" Similarly, the court noted that, via a CRP contract, the government is using the taxpayer's land for the government's own purpose of removing sensitive cropland from production and other environmental purposes for the benefit of the public. Accordingly, the court held that "the 2006 and 2007 CRP payments were 'consideration paid [by the government] for use [and occupancy] of Morehouse's property' and thus constituted rentals from real estate fully within the meaning of IRC §1402(a)(1)."

The 8th Circuit reversed the Tax Court and distinguished the 6th Circuit's *Wuebker* opinion by holding that CRP payments to a nonfarmer are not subject to SE tax. The court also held that CRP payments at issue (paid before 2008) qualify as "rentals from real estate" because they were payments for the government's use and occupancy of the taxpayer's land.

> **Note.** Because of the statutory change to IRC §1402(a)(1) by virtue of the 2008 Farm Bill, CRP payments paid after 2007 are "rentals from real estate" for taxpayers receiving social security retirement or disability payments. The dissent made this point clear when it stated, "whether CRP payments that the government made after December 31, 2007 or currently makes to a nonfarmer qualify as rentals from real estate under amended §1402(a)(1) is a question that the court's decision does not resolve." This seems to indicate that this judge views CRP payments as "rentals from real estate" in every situation in which they are paid after 2007. Thus, the 2008 amendment to IRC §1402(a)(1) renders the differing holdings of the 8th Circuit and the 6th Circuit on this particular point meaningless. CRP payments paid after 2007 are "rentals from real estate."

80. *Morehouse v. Comm'r,* 769 F.3d 616 (8th Cir. 2014), *rev'g* 140 TC 350 (2013).

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

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

83. IRS Notice 2006-108, 2006-2 CB 1118.

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

Inside the 8th Circuit (AR, IA, MN, MO, NE, ND, SD). The 8th Circuit's reversal of the Tax Court means that nonfarmers do not have to pay SE tax on CRP payments, at least within the 8th Circuit. If there is a nexus with an existing farming operation, an active farmer still must pay SE tax on CRP payments unless the 2008 Farm Bill provision applies to them. However, nonfarmers and nonmaterially participating farm landlords are given relief within the 8th Circuit.

For CRP rents paid after 2007, the issue is whether the recipient is a materially participating farmer. The 8th Circuit's opinion is helpful in arguing that a nonfarmer is not materially participating with respect to the CRP. The majority stated, "The record indicates that Morehouse never personally farmed the CRP properties and that he tilled and fertilized the land so that he could establish grass covering of which he could make no economic use. We suspect, respectfully, that the Commissioner's characterization of Morehouse's activities as even remotely resembling a 'farming operation' would be met with a fair modicum of skepticism by anyone who has carried on (or closely observed) such an enterprise." This language could support an argument that an active farmer who has CRP ground that is, for example, located in a location distant from the actual farming operation need not pay SE tax on CRP rents, due to lack of nexus.

> **Note.** Even though the court's opinion technically applies only to CRP rents paid before 2008, it would be difficult for the IRS to argue that a nonfarmer is materially participating with respect to land in the CRP. In addition, for taxpayers in the 8th Circuit, the court's expansive view of the term "rent" provides authority for asserting that any taxpayer's receipt of CRP payments is not subject to SE tax, because it is real estate rental income.

Inside the 6th Circuit (KY, MI, OH, TN). CRP rental payments are considered farm income and not real estate rental income, as long as nexus exists with the farming operation. These payments are not excluded from SE income due to the real estate rent exception of IRC §1402(a)(1). Because the taxpayers in *Wuebker* conducted a farming operation, the court held that the CRP payments are subject to SE tax due to the nexus with the farming operation. Thus, a taxpayer without a farming operation could reasonably conclude that CRP payments are not subject to SE tax due to lack of nexus with a farming operation. For example, an Ohio farmer who owns hunting property in Colorado that included CRP acres would not be subject to SE tax on the CRP payments received.

Outside Both 6th and 8th Circuits. For individuals receiving CRP payments, the payments could be treated as real estate rents and are thus excluded from SE income under IRC §1402(a)(1). This conclusion relies upon the full Tax Court opinion rendered in *Wuebker* that CRP payments are rents.

All taxpayers are allowed to exclude CRP payments from SE income if they receive social security retirement or disability payments.

INCOME DEFERRAL FOR AGRICULTURAL PRODUCERS

DEFERRAL OF LIVESTOCK SALES

Two statutory deferral strategies are available to livestock owners when livestock are sold.

- 1-year deferral
- Involuntary conversion treatment

A nonstatutory option involves the use of a deferred-payment contract. Deferred-payment contracts for grain and livestock sales are discussed later in this section.

One-Year Deferral

IRC §451(e) provides for a 1-year deferral of the income derived from the sale of **excess** livestock when the sale occurs because of drought, flood, or other weather-related conditions. Five conditions must be satisfied to be eligible for a 1-year deferral.

1. The taxpayer's principal business is farming.

> **Note.** Farming, as defined by IRC §6420(c)(3), includes the raising or harvesting of any agricultural or horticultural commodity, including the raising, shearing, feeding, caring for, training, and management of livestock, bees, poultry, and fur-bearing animals and wildlife by an owner, tenant, or farm operator. The taxpayer may request a letter ruling from the IRS if it is necessary to determine whether the taxpayer's principal business is farming.[85]

2. The taxpayer uses the cash method of accounting.
3. Under normal business practices, the sale would not have occurred in the current year except for the drought, flood, or other weather conditions.
4. The drought, flood, or other weather condition resulted in the area being designated as eligible for assistance by the federal government.[86]
5. Only livestock in excess of the number that normally would have been sold under usual business practices is eligible for the deferral.

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85. The IRS ruled favorably that an individual's principal business was farming when the individual had off-farm income of $65,000 and also earned $121,000 from a cattle ranching business. Ltr. Rul. 8928050 (Apr. 18, 1989).

86. The livestock need not be raised within the actual area of drought or other weather-related condition, and the sale does not need to occur within the designated area. However, the early sale must have occurred solely on account of the drought or other condition and its impact on water, grazing, or other requirements of the animals within the area. Treas. Reg. §1.451-7(c); IRS Notice 89-55. The disaster area designation can be made by the president, the Department of Agriculture or any of its agencies, or by other federal departments or agencies.

The livestock may be either raised or purchased animals, and may be held either for resale (inventory livestock), or for productive use (depreciable livestock). Depreciable livestock includes purchased dairy, breeding, draft, or sporting-purpose animals.

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

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

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

If the taxpayer makes a deferral election in successive years, Treas. Reg. §1.451-7(f) specifies that the amount deferred from one year to the next is not considered received from the sale of livestock during the later year. In addition, when determining the taxpayer's normal business practice for the later year, earlier years for which a deferral election was made should not be considered. Thus, if a taxpayer defers excess livestock sales from 2014 to 2015 under an IRC §451(e) election, those deferred sales are not taken into account again in 2015 in making a determination as to whether excess head were sold in 2015.

The statement of election to postpone gain for one year under IRC §451(e) must include the taxpayer's name and address and the following information.

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

A taxpayer who sells livestock early due to weather-related conditions that are given federal disaster status may make the 1-year deferral election at any time within the four years following the close of the first tax year in which any gain is recognized.[87]

Involuntary Conversion Treatment

IRC §1033 applies the involuntary conversion rollover rule in two broad situations, allowing taxpayers who are forced to sell livestock involuntarily to defer the gain into replacement property. Under either of the following circumstances, gains from livestock sales can be deferred by reinvesting the proceeds.

1. Livestock were destroyed by disease.[88]
2. Livestock (other than poultry) held by a taxpayer for draft, breeding, or dairy purposes were sold in excess of usual business practices due to drought, flood, or other weather-related conditions.[89]

Note. The sale or exchange of the excess livestock must be solely on account of drought or weather conditions that affect the water, grazing, or other needs of the livestock. However, it is not necessary that the livestock be held in a drought or flood area, or that the actual sale occurred in the affected area.[90]

Like the provisions for the 1-year deferral related to weather conditions, the involuntary conversion treatment is limited to the livestock sold in excess of the number that would have been sold under the taxpayer's usual business practice.[91]

IRC §1033 allows taxpayers to elect to defer gains that are realized from involuntary conversions (the destruction, theft, seizure, or condemnation of property) if the taxpayer has properly complied with the election requirements. In addition, the taxpayer must make a timely purchase of qualified replacement property.

In general, the replacement property must be "similar or related in service or use."[92] This means, for example, that dairy cows should be replaced by dairy cows.[93] However, this general provision was amended in certain situations due to 2004 legislation that applies to livestock sales reported on returns with a due date after 2002. A taxpayer can replace involuntarily converted livestock sold early due to drought, flood, or other weather-related conditions or soil or other environmental contamination with other farm property, if it is **not feasible** for the taxpayer to reinvest the proceeds in similar or related-use livestock.

As a result of this provision, a taxpayer can satisfy the §1033 replacement rule by reinvesting in farm equipment or other tangible personal property for farming use. This applies to a taxpayer who is forced to sell cattle early because of drought or other weather-related conditions in a federally designated disaster area and who is unable to reinvest the proceeds in replacement livestock due to extended drought or other weather conditions. Likewise, if it is not feasible to reinvest the proceeds from involuntarily converted livestock into other like-kind livestock due to soil or other environment contamination, the proceeds can be invested into property that is not like-kind or real estate used for farming purposes.[94]

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87. IRC §451(e)(3).
88. IRC §1033(d).
89. IRC §1033(e).
90. Treas. Reg. §1.1033(e)-1(b).
91. Treas. Reg. §1.1033(e)-1(c).
92. IRC §1033(a)(1).
93. Treas. Reg. §1.1033(e)-1(d).
94. IRC §1033(f).

Example 5. Bart is a cattle rancher. Due to an extended drought in the areas where his special feed is grown, the price of feed increases to such a level that Bart can no longer afford to feed his livestock. In 2012, he was forced to sell three times as many cattle as he would have under normal business circumstances. Because the drought continues to affect the cost of feed, it is not feasible for Bart to reinvest in more cattle. In 2015, instead of buying replacement cattle, he reinvests the proceeds by purchasing farm equipment. This equipment qualifies as replacement property because it is not feasible for Bart to reinvest in more cattle during the replacement period.

Example 6. Jethro is a cattle rancher. In 2012, he was forced to sell his entire herd of cattle because his grazing land was contaminated by an oil spill. It is not feasible for Jethro to replace the herd because the entire environment on his ranch is contaminated. In 2015, he reinvests the proceeds into farmland in a distant state. This farmland qualifies as replacement property because the herd was sold due to environmental factors.

Observation. Farmers that sell raised breeding or dairy animals that can be taxed at the capital gain rates may prefer to recognize the gain rather than deferring it. This is particularly true if depreciation deductions on the replacement animals reduce income subject to higher ordinary income tax rates (and potentially SE tax). This might be especially applicable when the replacement animals qualify for expensing under IRC §179.

Replacement Period. In general, the purchase of replacement property under the involuntary conversion rules of §1033 must occur within **two years** after the close of the first year in which any gain is realized. This rule also applies to gains on livestock that are sold because of disease.[95]

However, the applicable replacement period for draft, breeding, or dairy livestock sold early because of drought, flood, or other weather-related conditions in an area designated as eligible for federal disaster assistance is **four years** after the close of the first tax year in which any part of the gain on conversion is realized.[96] In addition, the IRS is given authority on a regional basis to extend the replacement period if the weather-related conditions that resulted in the application of this provision continue for more than three years.[97]

Making the Election to Defer the Gain. To make the election to defer the gain, the taxpayer should include the following information with the tax return for the year that the gain on the conversion is first realized and deferred under §1033.[98]

- Evidence of the drought, flood, or weather-related condition that caused the early sale
- The computation of the gain realized
- The number and kind of livestock sold
- The number of each kind of livestock that would have been sold under normal business practices

The election can be made at any time within the normal statute of limitations for the period in which the gain is recognized, assuming it is before the expiration of the period within which the converted property must be replaced.[99] If the election is filed to defer gain and eligible replacement property is not acquired within the 4-year replacement period, an amended return for the year in which the gain was originally realized must be filed to report the gain.

95. IRC §1033(a)(2)(B).
96. IRC §1033(e)(2).
97. IRC §1033(e)(2)(B).
98. Treas. Reg. §1.1033(e)-1(e).
99. IRC §1033(a)-2(c)(2). See also CCA 200147053 (Sep. 28, 2001).

Reporting the Purchase of Replacement Property. For the tax year in which the livestock are replaced, the taxpayer should include the following information with the tax return.

- The purchase date of replacement livestock
- The cost of the replacement livestock
- The number and kind of replacement livestock

DEFERRED-PAYMENT ARRANGEMENTS

Agricultural producers typically have income streams that are less consistent from year to year than do nonfarm salaried individuals. Because of this, agricultural producers often try to structure transactions to smooth out income across tax years and for other tax-related purposes. One technique used to accomplish these goals involves deferral arrangements. These transactions can be structured in various ways but, to properly defer income, some form of a "deferred-payment contract" must be utilized.

The general rule for cash-basis taxpayers is that income is accounted for in the tax year that it is either actually or constructively received. The IRS published regulations specifying when income is deemed constructively received. The **constructive receipt doctrine** is the primary tool that the IRS uses to challenge deferral arrangements. Under the regulations, a taxpayer is deemed to have constructively received income when any of the following occurs.[100]

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

> **Note.** Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.[101]

A **deferred-payment contract** is taxed under the installment payment rules. IRC §453(b)(2) disallows the installment method of accounting for dealer dispositions of personal property, and farmers normally are considered "dealers" because they regularly dispose of personal property such as grain and livestock. However, IRC §453(l)(2)(A) excludes the disposition of "any property used or produced in the trade or business of farming" from being treated as a dealer disposition. Thus, farmers can sell grain and livestock via deferred-payment contracts and the gain is not included in income in the year of sale. Recognition of gain can be postponed until the year of receipt.

> **Note.** Chapter 9 of the IRS's *Farmers Audit Technique Guide* (ATG) provides a summary of income deferral and constructive receipt rules. The ATG provides a procedural analysis for examining agents to use in evaluating deferred-payment arrangements. The ATG is available at **uofi.tax/15a4x1** [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Farmers-ATG]. Additional information can be found on page 5 of IRS Pub. 225, *Farmer's Tax Guide.*

100. Treas. Reg. § 1.451-2(a).

101. Ibid.

Straightforward Deferral Arrangements

The most likely way for a farmer to avoid an IRS challenge of a deferral arrangement is for the farmer to enter into a sales contract with a buyer that calls for payment in the next tax year. This type of contract simply involves the buyer's **unsecured** obligation to purchase the agricultural commodities from the seller on a particular date. Under this type of deferral contract, the price of the goods is set at the specified time for delivery, but payment is deferred until the next year. If the contract is bona fide and entered into at arm's length, the farm seller has no right to demand payment until the following year, and if the contract (as well as the sale proceeds) is nonassignable, nontransferable, and nonnegotiable, then the deferral should not be challenged by the IRS.[102]

The following criteria for a deferred payment contract should be met in order to successfully defer income to the following year.

1. The seller should obtain a written contract that, under local law, binds both the buyer and the seller. A note should not be used.
2. The contract should state clearly that under no circumstances would the seller be entitled to the sales proceeds until a specific date (i.e., a date in a future tax year). The earliest date depends on the farmer's tax yearend.
3. The contract should be signed before the seller has the right to receive any proceeds, which is normally before delivery.
4. The buyer should not credit the seller's account for any goods the seller may want to purchase from the buyer during the year of the deferred-payment contract (such as seed and/or fertilizer). Instead, such transactions should be treated separately when billed and paid.[103]
5. The contract should state that the taxpayer has no right to assign or transfer the contract for cash or other property.
6. The contract should include a clause that prohibits the seller from using the contract as collateral for any loans or receiving any loans from the buyer before the payment date.
7. The buyer should avoid sales through an agent in which the agent merely retains the proceeds. Receipt by an agent usually is construed as receipt by the seller for tax purposes.
8. If a third-party guarantee or standby letter of credit is issued to secure the contract, the guarantee or letter of credit should be nonnegotiable, nontransferable, and only eligible to be drawn on in the event of default.
9. Price-later contracts should state that in no event can payment be received prior to the designated date, even if a price is established earlier.[104]
10. The contract may provide for interest. Interest on an installment sale is reported as ordinary income in the same manner as any other interest income. If the contract does not provide for adequate stated interest, part of the stated principal may be recharacterized as imputed interest or as interest under the original issue discount rules, even if there is a loss. Unstated interest is computed by using the applicable federal rate (AFR) for the month in which the contract is made.

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102. See, e.g., Rev. Rul. 58-162, 1958-1 CB 234 (Deferral of income from sale of grain effective to delay income recognition until year of actual receipt. IRS noted that if taxpayer could control timing of payment, then constructive receipt would be present).

103. For example, the sale of corn to the local cooperative from which the seller also buys fertilizer should not result in the fertilizer purchase being applied against the amount owed to the seller. The fertilizer must be separately billed and paid for.

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

Deferral Contracts Coupled with Letters of Credit or Escrow Accounts

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

> **Note.** The funds held in escrow, and the accrued interest on those funds, are taxable as income in the year that they provide an economic benefit to the taxpayer. Simply because an escrow account bears interest does not mean that the account constitutes an economic benefit.[105]

The key case law regarding letters of credit or escrow accounts used in the context of deferral arrangements includes the following.

- In *Watson v. Comm'r*,[106] the court held that the receipt of a letter of credit was synonymous with receiving cash in the year of sale. The taxpayers sold cotton bales under a deferred-payment agreement in return for a letter of credit that was to be honored and accepted after the end of the tax year in which it was received. The court noted that the letter of credit could be assignable under state (Texas) law and also could be readily marketable.
- In *Griffith v. Comm'r*,[107] 16,000 bales of cotton were sold in 1973 under a deferral contract specifying that the buyer would pay the selling price in five annual installments beginning in 1975. The interest rate on unpaid installments was set at 7% annually. The buyer was given a warehouse receipt for the cotton, and the seller received a letter of credit for the full-face amount of the cotton's total deferred purchase price. The letter of credit specified that prepayment was not allowed and that the letter of credit was not transferable. The letter of credit allowed the seller to draw on the buyer's account but only after a certification was received indicating that the buyer was in default on the contract. The court ruled that the full contract amount was constructively received in the year the contract was executed. Importantly, even though the standby letter of credit was nontransferable, the proceeds were transferable under state law. The court also determined that the seller had no nontax business purposes for entering into the deferral arrangement.
- In *Reed v. Comm'r*,[108] the court held that a taxpayer's "unconditional right to future payment from an irrevocable escrow account" did not constitute taxable income in the year the escrow account was created. The key, the court said, was whether the taxpayer received a present beneficial interest in the escrow funds such that the funds were, in reality, the same as investment income. An unconditional promise that the taxpayer would ultimately be paid was not enough to create a beneficial interest that would cause the funds in the account to be presently taxable.
- In *Busby v. Comm'r*,[109] the taxpayer set up a deferred-payment arrangement with a cotton gin. The gin created an irrevocable escrow account. The court held that deferral was achieved because the taxpayer did not have any right to the funds in the account until the year after the year of sale of the cotton. In addition, the deferral arrangement resulted from an arm's-length negotiation between the parties.

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

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

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

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

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

- In *Scherbart v. Comm'r*,[110] the IRS challenged a deferral arrangement that a member of a farmer's cooperative had with the cooperative regarding value-added payments paid late in the tax year. The taxpayer entered into a "uniform marketing agreement" with the cooperative that served as the taxpayer's agent under the agreement. The agreement obligated the taxpayer to deliver corn to the cooperative in a specified amount. The cooperative made "value-added" payments to members in the year after the year in which corn deliveries were made. However, the cooperative also had the discretion to issue value-added payments near the end of the year in which the corn deliveries were made. The court held that the deferral of the value-added payments involved self-imposed limitations on the receipt of income and that the cooperative was the taxpayer's agent. The court also held that the value-added payments were not installment payments. Therefore, the taxpayer could not report the receipt of the payments under the installment method.[111]

Third-Party Sales

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

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

- *U.S. v. Pfister,*[112] involved the sale of cattle through a commission company. The commission company sold the cattle and mailed the net proceeds to the farmer on December 12, 1946. The check was in the farmer's post office box before the end of 1946, but the farmer did not check the box until January 1, 1947. The court held that the commission company acted as the farmer's agent and their receipt of the sale proceeds was attributable to the farmer. Thus, the farmer was deemed in constructive receipt of the sale proceeds in 1946.

Note. Livestock deferral arrangements can be difficult due to the Packers and Stockyards Act (PSA).[113] The *Pfister* court noted that under the PSA, a livestock market cannot buy consigned animals for resale via its owners, officers, agents, or employees. The IRS takes the position that livestock sales under the PSA are consignment contracts that create an agency relationship.[114] However, one court held that a deferral arrangement involving the sale of livestock was effective in spite of the PSA provision because the arrangement imposed "substantial qualifications and restrictions" that defeated constructive receipt and amounted to a substantial limitation.[115] The IRS does not agree with the court's opinion.[116]

- In *Warren v. U.S.*,[117] the taxpayers grew cotton that they marketed to separate cotton gins in 1969 and 1970. The cotton gins also accepted bids from buyers at the taxpayer's request. The cotton buyer paid a set fee per bale purchased, and the farmer paid the cost to gin the cotton. The taxpayer accepted bids and then instructed the gin to complete the sale. The taxpayer had the option to receive the sale proceeds in the following year. One gin deposited the sale proceeds in its own account and later paid the grower directly. The other gin deposited the funds in an escrow account from which the bank later issued a check to the grower. For both 1969 and 1970, the taxpayer reported the income from these sales in the following year. The IRS determined that the income from the sales should have been reported in 1969 and 1970, respectively. The court held that the gins acted as the taxpayer's agent, with the result that the taxpayer recognized the income from the cotton sales in the year of the sale. The only limitation on receipt of the funds was self-imposed.

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

111. IRC §453.

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

113. 42 Stat. 159 (1921).

114. Rev. Rul. 70-294, 1970-1 CB 13.

115. *Levno v. U.S.,* 440 F.Supp. 8 (D. Mont. 1977).

116. Rev. Rul. 79-379, 1979-2 CB 204.

117. *Warren v. U.S.*, 613 F.2d 591 (5th Cir. 1980).

- In Rev. Rul. 72-465,[118] a farmer entered into a deferred-payment arrangement with a livestock market corporation. The farmer received the amount of the sale proceeds in the subsequent year. Deferral was not permitted because the farmer could reclaim the livestock before their resale, and the buyer could return the livestock if they failed to sell.

- In Rev. Rul. 73-210,[119] a farmer was a member of a farmers' cooperative and was required to market his cotton through the cooperative after it was ginned. Upon delivery to the cooperative, the farmer had the option of deferring payment for the cotton. The farmer entered into a deferral arrangement on October 1, 1970, with payment to be made in January 1971. The deferral arrangement was effective because at the time the farmer entered into the deferred-payment contract, he had no unqualified right to receive any payments in the year the contract was entered into and the contract was a bona fide arm's-length transaction.

Installment Reporting

For farmers that use the cash method of accounting, the installment method of reporting income can achieve income deferral for the sale of farm products.[120] Installment reporting is available for income derived from the sale of property that is not required to be included in inventory under the taxpayer's method of accounting. **Crops and livestock are inventory-type property but are eligible for installment reporting** if they are not required to be reported in inventory under the taxpayer's method of accounting (which is the case with those on the cash method).

For eligible transactions, installment reporting is automatic, unless the taxpayer makes an election not to use it. **An installment sale is a sale of property with the taxpayer receiving at least one payment after the tax year of the sale.** Thus, if a farmer sells and delivers grain in one year and defers payment until the next year, that transaction constitutes an installment sale. If desired, the farmer can elect out of the installment-sale method and report the income in the year of sale and delivery.

Example 7. Tom, an operating farmer, harvests his grain crop in the fall of 2015 and **delivers and sells** it to an elevator in accordance with a deferred-payment contract in December 2015. The contract calls for Tom to be paid in January 2016. This contract qualifies for installment sale treatment, but Tom could elect to report the income he receives in 2016 on his 2015 Schedule F.

The election out of installment sale reporting is all-or-nothing. Therefore, in the preceding example, Tom must either report income using the installment method or elect out of installment reporting for **all** the grain covered by the contract.

The election must be made by the due date, including extensions, of the tax return for the year of sale and not the year in which payment is received. The election is made by recognizing the entire gain on the taxpayer's applicable form rather than reporting the installment sale on Form 6252, *Installment Sale Income.*

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

118. Rev. Rul. 72-465, 1972-2 CB 233.

119. Rev. Rul. 73-210, 1973-1 CB 211.

120. IRC §453(b).

Once made, the election can only be revoked with the IRS's approval. A revocation of an election out of the installment method is retroactive, and it is not permitted when one of its purposes is to avoid federal income taxes.[121] However, in a 2006 letter ruling, the IRS granted a request to amend a tax return in order to elect out of the installment method. The request was granted because the taxpayers convinced the IRS that the installment sale election was incorrectly filed on the original return because of erroneous information.[122]

Note. The practitioner (or farmer-seller) must ensure that the amount of gain recognized in the year of disposition is not also recognized in the year of receipt. For this reason, it is suggested that a receivable be recorded for the amount of accelerated sales, with the entry being reversed after yearend.

Generally, if the taxpayer elects out of the installment method, the amount realized at the time of sale is the proceeds received on the sale date and the FMV of the installment obligation (future payments). If the installment obligation is a fixed amount, the full principal amount of the future obligation is realized at the time of the acquisition.

Manufacturers and sellers of farm equipment are **not** eligible for installment reporting.[123] In addition, the statute specifies that the Treasury can issue regulations denying installment sale treatment for property that is of a kind "regularly traded on an established market."[124] If such regulations were issued, they could have potential application to a wide array of agricultural products.

Installment Sales and the Death of the Seller. If a seller dies before receiving all of the payments under an installment obligation, the installment payments are treated as **income in respect of a decedent (IRD).**[125] Therefore, the beneficiary does not get a stepped-up basis at the seller's death. The gain is reported on the beneficiary's return and is subject to taxes at the beneficiary's applicable rate. The character of the payments remains identical to that of the seller. For example, if the payments were long-term capital gain to the seller, they are long-term capital gain to the beneficiary.

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

The only way to avoid possible IRD treatment on installment payments appears to be for the seller to elect out of installment sale treatment. IRD includes sales proceeds "to which the decedent had a contingent claim at the time of his death."[126] The courts have held that the appropriate inquiry regarding installment payments is whether the transaction gave the decedent, at the time of death, the right to receive the payments.[127] This means that the decedent holds a contingent claim at the time of death that does not require additional action by the decedent. In that situation, the installment payments are treated as IRD.[128]

121. Treas. Reg. §15a.453-1(d)(4).

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

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

124. IRC §453(k)(2).

125. IRC §691(a)(4).

126. Treas. Reg. §1.691(a)-1(b)(3).

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

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

SALE OF FARM PARTNERSHIP INTEREST

When a partner sells or exchanges their partnership interest, they generally recognize a capital gain or loss on the sale.[129] There is an exception to this rule for amounts received by the partner that are attributed to **unrealized receivables**[130] or **inventory.**[131] When the partnership sells these assets, also known as **hot assets,** it recognizes ordinary income or loss on the sale. Therefore, in the sale or exchange of a partnership interest, amounts attributed to the partner's share of hot assets are generally subject to ordinary income tax treatment.[132] This prevents a partner from transforming ordinary income to capital gain through the sale of the partnership interest.

Because of the special tax treatment reserved for hot assets, it is crucial that practitioners and agricultural producers clearly understand which assets fall into these categories. This section provides general guidelines for identifying and categorizing unrealized receivables and inventory in a farm partnership.

Note. For a more in-depth discussion on the sale or exchange of a partnership interest, see the 2011 *University of Illinois Federal Tax Workbook,* Chapter 4: Partnerships.

UNREALIZED RECEIVABLES

The first category of hot assets is unrealized receivables. This category includes the right to payment (to the extent payments were not previously includable in partnership income) for the following.

1. Goods delivered or to be delivered (to the extent the proceeds would be treated as amounts received from the sale or exchange of property other than a capital asset)
2. Services rendered or to be rendered[133]

Goods Delivered or to be Delivered

In the farming context, unrealized receivables falling into the **first category** include property used in a trade or business subject to depreciation or amortization (as defined by IRC §1245). This category also covers any real property that was depreciated (including as defined by IRC §1250), such as the following.

- Farming equipment[134]
- Livestock (defined as horses, cattle, hogs, sheep, goats, and mink, but not poultry)[135]
- Fences and drainage tile[136]
- Property used for bulk storage of fungible commodities (grain bins)[137]
- Silos[138]

129. IRC §741.
130. IRC §751(c).
131. IRC §751(d).
132. IRC §751(a).
133. IRC §751(c).
134. IRC §1245(a)(3)(A).
135. Treas. Reg. §1.1245-3(a)(4).
136. IRC §1245(a)(3)(C).
137. IRC §1245(a)(3)(B)(iii).
138. Ibid.

- Single-purpose agriculture or horticulture buildings (hog production facility or greenhouse)[139]
- Barns, storage sheds, or work sheds[140]
- Recapture of soil and water conservation expenditures with respect to farmland[141]

Services Rendered or to be Rendered

Unrealized receivables falling into the category of services **rendered or to be rendered include the present value** of ordinary income attributable to contract rights to future payments for goods to be delivered or services to be rendered.[142] Such rights must have arisen under contracts or agreements in existence at the time of sale or distribution, even if the partnership could not enforce payment until a later time. Unrealized receivables include the rights to payment for work or goods begun but incomplete at the time of the sale or distribution.[143] This category of unrealized receivables may include the present value of ordinary income attributable to contract rights from the following agriculture-related contracts.

- Grain or livestock deferred-payment contracts
- Accounts receivable of a cash-method partnership
- Notes from the sale of assets reported under the installment method
- Lease contracts, including those for the cash rent of farmland
- Contracts for the production of commodities

Courts have clarified that unrealized receivables include binding long-term management contracts that cannot be terminated at the will of the party for whom the partnership is performing the services.[144]

INVENTORY

Inventory is the second category of hot assets. The following types of property are included in this category.

1. Partnership property described in IRC §1221(a)(1)
2. Any other partnership property other than a capital asset or property described in IRC §1231 when it is sold or exchanged by the partnership[145]

IRC §1221(a)(1) Assets

IRC §1221(a)(1) states that the term **capital asset** means property held by the taxpayer (whether or not connected with their trade or business) but does **not** include the following.

1. Stock in trade of the taxpayer or other property of a kind that would properly be included in the taxpayer's inventory if it is on hand at the close of the tax year
2. Property held by the taxpayer primarily for sale to customers in the ordinary course of the trade or business

139. IRC §1245(a)(3)(D).
140. IRC §1250.
141. IRC §§751(c) and 1252(a).
142. Treas. Reg. §1.751-1.
143. Treas. Reg. §1.751-1(c)(1).
144. See, e.g., *U.S. v. Woolsey,* 326 F.2d 287, 291 (5th Cir. 1963).
145. IRC §751(d).

Under this definition, inventory items in the context of a farm partnership include the following.

1. Harvested crops
2. Feeder livestock
3. Poultry
4. Tools
5. Repair parts
6. Supplies
7. Seed
8. Feed
9. Fertilizer[146]

Other Partnership Property

The second category of inventory items is extremely broad, encompassing "any other" property that, upon sale by the partnership, is not considered a capital asset or IRC §1231 property. The following farm partnership assets **are** considered inventory items because they are excluded under the IRC §1231 definition.

- Single-purpose agricultural or horticultural structures, grain bins, or farm buildings held for more than one year[147]
- Personal property (other than livestock) not held for more than one year from the date of acquisition[148]
- Cows and horses held for less than 24 months from the date of acquisition[149]
- Other livestock (regardless of age, but not including poultry) held by the taxpayer for less than 12 months from the date of acquisition[150]

Property considered inventory under IRC §751(d) because they are generally not capital assets includes the following.

- Poultry[151]
- Farmland held for less than one year from the date of acquisition[152]

Unharvested Crops

Specifically excluded from inventory are unharvested crops on land used in a trade or business and held for more than one year, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted) at the same time and to the same person.[153] It is likely that unharvested crops would **not** be considered inventory, even if these criteria were not met.[154]

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146. *Levine v. Comm'r,* TC Memo 1962-68 (Mar. 28, 1962).
147. IRC §1231(b)(1).
148. Ibid.
149. IRC §1231(b)(3)(A).
150. IRC §1231(b)(3)(B).
151. IRC §1231(b)(3) (Poultry is excluded from the definition of livestock, subject to IRC §1231 rules).
152. IRC §1231(b)(1).
153. IRC §1231(b)(4).
154. *The Problem of Hot Assets in Farm Partnerships.* Joy, David; Hahn, Randall; and Karnes, Allan. 1985. Southern Illinois University Law Journal. [nationalaglawcenter.org/publication/joy-hahn-karnes-the-problem-of-hot-assets-in-farm-partnerships-1985-southern-illinois-univ-l-j-655-685-1985/wppa_open/] Accessed on Apr. 8, 2015.

MEALS AND LODGING

Meals and lodging furnished in-kind to an employee (and the employee's spouse and children) **for the convenience of the employer** on the employer's **business premises** are excluded from the employee's gross income.[155] In addition, the value of meals and lodging furnished for the employer's convenience is not wages for FICA and FUTA purposes.[156] With respect to employer-provided lodging, the employee must accept the lodging as a condition of employment.[157]

The meals and lodging are 100% deductible by the employer (as a noncash fringe benefit) if they are provided in-kind on the business premises for the benefit of the employer.[158] The meals and lodging provided to employees are not considered compensation. However, the employer may deduct them as an ordinary and necessary business expense.[159]

EXCLUSION OF EMPLOYER-PROVIDED MEALS

On the Business Premises

The meals must be furnished **on the employer's business premises** in order for their value to be excluded from an employee's income.[160] The **business premises** is the place of employment,[161] where the employee performs a significant portion of their duties or the employer conducts a significant portion of its business. Thus, the meals cannot be furnished at a convenient location that is near the business premises.[162]

For the Convenience of the Employer

The meals must also be provided for the convenience of the employer in order for them to be excluded from an employee's income. If they are not, the value of the meals is subject to FICA and FUTA taxes.[163] The key is that the meals (or lodging) **must not be intended as compensation.** On this point, an employment contract that fixes the terms of employment is not controlling by itself. The same is true for a state statute.[164] In essence, the determination of the reason an employer provides meals and lodging to employees is based on objective facts and not on stated intentions. **There must be some reasonable connection between providing employees with meals and lodging and the business interests of the employer.**

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155. IRC §119. The value of meals and lodging is includable in an employee's income if the employee can choose to receive additional compensation instead of receiving the meals or lodging in-kind.

156. *Rowan Companies, Inc. v. U.S.*, 452 U.S. 247 (1981).

157. IRC §119(a)(2); Treas. Reg. §1.119-1(b)(3).

158. IRC §162.

159. Ibid. The exclusion of the value of meals and lodging from an employee's income has no bearing on the employer's deduction. See, e.g., *Harrison v. Comm'r,* TC Memo 1981-211 (Apr. 28, 1981).

160. IRC §119(a)(1).

161. Treas. Reg. §1.119-1(c)(1).

162. Rev. Rul. 71-411, 1971-2 CB 103 (Even though meals were not served at the place of employment, they were served where a major part of the employer's business was conducted).

163. Rev. Rul. 81-222, 1981-2 CB 205; and see Ltr. Rul. 9143003 (Jul. 11, 1991) (Value of meals included in employees' income; not reasonable to believe wages excludable).

164. IRC §119(b)(1) (Employment contract or state statute not determinative of whether meals or lodging are intended as compensation).

Example 8. FarmCo operates on property that it leases from its shareholders/officers. FarmCo requires the corporate officers to be on the farm premises at all times to monitor activities and deal with issues as they arise. Farmco reimburses the shareholders' grocery expenses. In addition, the shareholders' residence is on the farm and the meals are cooked in the shareholders' home.

Tax Result. Similar circumstances exist in *Dobbe v. Comm'r*.[165] In that case, the court held that such an arrangement was for the shareholders' own convenience and not for the convenience of the employer. Although the shareholders were engaged in day-to-day farm operations and may have eaten some meals while dealing with farm issues, the court held that they did so for their own convenience. In addition, the court noted that other employees were not treated similarly. The corporation failed to establish that the reimbursement was necessary to ensure that qualified employees would be available to address unexpected issues of the farm corporation.

Furthermore, it was not proved that the lease covered the residence on the property. Consequently, the court concluded that the meals were furnished to the shareholders in their personal residence rather than on the employer's business premises.

Note. For leased residences, it is advisable to have a written lease detailing the amount of rent the corporation pays and detailing the corporation's right to access the residence.

Cash meal allowances or reimbursements are includable in gross income to the extent the allowance constitutes compensation.[166] Under Temp. Treas. Reg. §1.132-6T, gross income does not include the value of a de minimis fringe benefit provided to an employee. Occasional meal money provided to an employee because overtime work necessitates an extension of the employee's normal workday is excluded as a de minimis fringe. However, meal allowances provided on a routine basis for overtime work are not "occasional meal money" for purposes of the de minimis rules.[167] Accordingly, they are treated as wages for FICA and withholding purposes (and presumably for FUTA as well).[168]

Note. Regarding what is considered "meals," the U.S. 3rd Circuit Court of Appeals, in a case involving employer-provided housing that met the test for excludability (discussed later), held that the cost of groceries (including such things as napkins, toilet tissue, and soap) were excludable from the employees' income.[169] The court reached this conclusion because the employee was required to live on the business premises as a condition of employment.[170]

Treatment of Meals as a Fringe Benefit

If more than half of the employees to whom meals are provided on an employer's premises are furnished meals for the convenience of the employer, then all the meals are treated as furnished for the employer's convenience.[171] If this test is met, the value of all meals is excludable from the employee's income and is deductible by the employer.

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165. *Dobbe v. Comm'r,* TC Memo 2000-330 (Oct. 25, 2000).

166. See, e.g., Ltr. Rul. 9801023 (Sep. 30, 1997). See also *Koven v. Comm'r*, TC Memo 1979-213 (May 29, 1979).

167. Temp. Treas. Reg. §1.132-6T(d)(2).

168. Ltr. Rul. 9148001 (Feb. 15, 1991).

169. *Jacob v. U.S.,* 493 F.2d 1294 (3rd Cir. 1974).

170. The IRS does not agree with the court's conclusion. See Ltr. Rul. 9129037 (Apr. 23, 1991). In addition, the U.S. Tax Court has reached a different conclusion (see *Tougher v. Comm'r,* 51 TC 737 (1969)). As a result, the IRS does not follow the 3rd Circuit's opinion outside of the 3rd Circuit and takes the position in those jurisdictions that the value of such items is wages for FICA purposes.

171. IRC §119(b)(4).

Employee Meals Provided at a Discount

In Ltr. Rul. 7740010, an employer charged employees for meals furnished on the business premises. The employees could purchase the meals but were not required to. The IRS ruled that the excess of FMV over the amount charged for the meals was taxable income to the employees.[172]

EMPLOYER-PROVIDED LODGING

In order for the value of lodging to be excluded from an employee's wages, the following conditions must be met.

- The employer must furnish the lodging to the employee.
- The employee must be required to accept the lodging on the business premises as a **condition of employment** and for the **convenience of the employer.**[173]

The term **lodging** includes not only the value of the residence but also such items as heat, electricity, gas, water, and sewer service, unless the employee contracts for the utilities directly from the supplier.[174] Lodging also includes household furnishings[175] and telephone services.[176]

> **Note.** If the employee is required to pay for the utilities without reimbursement from the employer, the utilities are not furnished by the employer and are not deductible by the employee.[177]

The lodging must be provided in-kind.[178] Cash allowances for lodging (and meals) are includable in gross income to the extent that the allowance constitutes compensation.[179]

> **Observation.** A residence provided for farm employees on the premises likely qualifies as 20-year MACRS property.

As a Condition of Employment

The employee must accept the employer-provided lodging as a condition of employment. **That can only occur if the employee's acceptance of the lodging is necessary for the employee to properly perform their job duties.** It makes no difference if the employee is required to accept the employer-provided lodging. The key is whether the employer-provided lodging is necessary for the performance of the employee's duties. Thus, the standard is an objective one. It is immaterial, for example, that corporate documents (such as a board resolution) require the employee to live in corporate-provided lodging.[180]

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172. Ltr. Rul. 7740010 (Jun. 30, 1977).

173. IRC §119(a)(2).

174. Rev. Rul. 68-579, 1968-2 CB 61; *Harrison v. Comm'r*, TC Memo 1981-211 (Apr. 28, 1981) (Amounts for gas and electricity paid by corporation in grain and dairy operation were necessary for residences to be habitable and so excludable from income of employees); *Vanicek v. Comm'r*, 85 TC 731 (1985), *acq.,* 1986-1 CB 1 (Portion of cost of utilities for residence provided by employer not deductible because of lack of evidence showing how utility cost could be apportioned between business and personal use). See also *Inman v. Comm'r*, TC Memo 1970-264 (Sep. 21, 1970); *McDowell v. Comm'r*, TC Memo 1974-72 (Mar. 26, 1974) (Propane, gas, telephone, and utilities excludable in addition to food and depreciation; taxpayers lived on ranch eight months out of year with closest town 80 miles away).

175. *Turner v. Comm'r,* 68 TC 48 (1977).

176. *Hatt v. Comm'r,* TC Memo 1969-229 (Oct. 28, 1969).

177. *Turner v. Comm'r,* 68 TC 48 (1977) (Costs of utilities and furnishings purchased by welder for house in which employer required welder to reside not deductible because utilities and furnishings not provided by employer).

178. See Ltr. Rul. 9801023 (Sep. 30, 1997) (Cash housing allowance provided to employee was not excludable from income; lodging also not on business premises); Ltr. Rul. 9824001 (Feb. 11, 1998).

179. Treas. Reg. §1.119-1(e).

180. See, e.g., *Peterson v. Comm'r,* TC Memo 1966-196 (Sep. 2, 1966); *Winchell v. U.S.,* 564 F.Supp. 131 (D. Neb. 1983).

Convenience of the Employer

The convenience-of-the-employer test is essentially the same as the requirement that lodging be provided as a condition of employment.[181] Therefore, if lodging is deemed provided as a condition of employment, it is also deemed provided for the convenience of the employer.[182]

Note. In Rev. Rul. 68-354, the IRS said that Treas. Reg. §1.119-1(a)(3)(i), which governs the convenience-of-the-employer test regarding meals, also applies to lodging. Thus, even if there is a compensatory reason for providing the lodging, the lodging is deemed to have been provided for the employer's convenience if there is a substantial noncompensatory business reason for providing it.

On the Business Premises

Meals must be furnished on the employer's business premises in order for them to be excluded from an employee's income.[183] For lodging, the employee must be required to accept the "lodging on the business premises of his employer."[184] Both meals and lodging must be provided on the business premises.

Note. The regulations specify that **business premises of the employer** generally means the employee's place of employment.[185] It is immaterial whether the meals and lodging are provided on premises that the corporation leases rather than owns. On this point, the regulations state, "For example, meals and lodging furnished in the employer's home to a domestic servant would constitute meals and lodging furnished on the business premises of the employer. Similarly, meals furnished to cowhands while herding their employer's cattle on leased land would be regarded as furnished on the business premises of the employer."[186]

Case Law. The courts have dealt with the business-premises issue in numerous cases. Following is a summary of some of the more relevant decisions.

- In *Dole v. Comm'r*,[187] the court held that **on the business premises,** for purposes of the lodging exclusion, meant living quarters constituting an integral part of business property or premises on which the employer carries on some of its business activities. **The court disallowed the exclusion, however, because the lodging in question was located approximately a mile from mills where the taxpayers were employed and, therefore, not on the business premises.** In addition, the employees were not required to accept the lodging as a condition of their employment.
- In *Comm'r v. Anderson*,[188] the employer owned a motel and built a house within two blocks of the motel for the manager and his family to live in. The employer paid for the home, utilities, laundry, cleaning expenses, milk, and groceries. The Tax Court held that the value of the meals and lodging were excludable from the employee's income because they were provided on the employer's business premises. However, the Appellate Court reversed the decision, pointing out that, to be excluded, meals or lodging must be provided either at the place where an employee performs a significant portion of his duties or on premises where the employer conducts a significant portion of the business.[189]

181. See, e.g., *Vanicek v. Comm'r,* 85 TC 731 (1985).
182. Rev. Rul. 68-354, 1968-2 CB 60.
183. IRC §119(a)(1).
184. IRC §119(a)(2).
185. Treas. Reg. §1.119-1(c). It does not necessarily matter if the lodging is not physically contiguous to the actual business premises if the employee conducts significant business activities in the residence. See, e.g., *Faneuil v. U.S.,* 585 F.2d 1060 (Fed. Cl. 1978).
186. Treas. Reg. §1.119-1(c)(1).
187. *Dole v. Comm'r*, 43 TC 697 (1965), *aff'd.,* 351 F.2d 308 (1st Cir. 1965).
188. *Comm'r v. Anderson*, 371 F.2d 59 (6th Cir. 1966), *rev'g* 42 TC 410 (1964).
189. Ibid.

- In *McDonald v. Comm'r*,[190] the taxpayers, a married couple, moved to Japan and the husband's employer reimbursed their cost of lodging in Japan. The court held that the value of the employer-provided lodging was includable in the employee's gross income to the extent it exceeded the amount of rent that the taxpayers paid. The court held that the lodging was not furnished for the employer's convenience, was not on the business premises, and was not provided as a condition of employment.

As mentioned earlier, whether the employer actually owns the property where the lodging (and meals) is provided is irrelevant.[191] The key is that the lodging (and meals) must be provided on the business premises, and ownership has no bearing on that fact.

- In *Benninghoff v. Comm'r*,[192] local government ownership of a home provided to a policeman was not sufficient to prove the home was on the business premises. Instead, the court ruled that there must be a "direct, substantial relationship" between the lodging and the interests of the employer. Under the facts of the case, that relationship was not present. Consequently, the value of the lodging was not excludable from income.

- In *Boykin v. Comm'r*,[193] the rental value of quarters provided on the grounds of a Veteran's Administration Hospital was excludable from the taxpayer-physician's gross income.

- In *Lindeman v. Comm'r*,[194] the taxpayer was the general manager of a hotel that was located on property that the taxpayer's employer leased. The IRS denied the exclusion of the value of the employer-provided lodging. However, the court held that it was immaterial that the hotel was on leased property. The key was that the employee performed a significant portion of his duties in the residential quarters on the employer's premises.

In most of the farm and ranch cases decided to date, whether the meals and lodging were provided on the business premises was not an issue. However, the following cases exemplify where it was an issue.

- In *Peterson v. Comm'r*,[195] the value of a home provided to the president of a poultry-breeding corporation adjacent to the corporation's poultry farm was included in the taxpayer's income. The court acknowledged that "the facility in question was on the business premises of the employer," but the court held that the taxpayer was not required to live on the premises as a condition of employment. In addition, the taxpayer failed to show that the housing was furnished for the convenience of the employer.

- In *Wilhelm v. U.S.*,[196] the value of food and lodging provided by a ranching corporation was not taxed to the shareholder-employees. The ranch was located in a remote location several miles from the nearest town. The court noted that the grass ranch put up very little hay and required constant attention by persons experienced in grass-ranch requirements to keep cattle alive. The court also noted that during snowstorms the cattle needed to be fed daily and moved, waterholes had to be kept open, and the cattle had to be protected against the hazards of being trapped or falling into ravines. Under these circumstances, the employees had no choice but to accept the facilities furnished by the corporate employer. The court ruled that the food and lodging were furnished to the employees not only for the convenience of the employer, but that they were indispensable in order to have the employees on the job at all times.

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190. *McDonald v. Comm'r*, 66 TC 223 (1976).

191. *See Bornstein v. Comm'r,* TC Memo 1978-278 (Jul. 25, 1978) (Apartment occupied by the taxpayer and supplied by the employer was not located at the employer's place of business; therefore, its value was not excludable from the employee's income).

192. *Benninghoff v. Comm'r*, 614 F.2d 398 (5th Cir. 1980), *aff'g*, 71 TC 216 (1978).

193. *Boykin v. Comm'r,* 260 F.2d 249 (8th Cir. 1958).

194. *Lindeman v. Comm'r*, 60 TC 609 (1973).

195. *Peterson v. Comm'r*, TC Memo 1966-196 (Sep. 2, 1966).

196. *Wilhelm v. U.S.*, 257 F. Supp. 16 (D. Wyo. 1966).

- The same court went further in 1994. In *Dilts v. U.S.*,[197] each shareholder-employee of a closely held farm corporation lived in a corporation-owned house on the business premises. The taxpayers met the burden of proving that the lodging furnished to them was indispensable to the proper discharge of their employment. This was true even though the corporation was located within a 10-minute drive from a residential area of a nearby town. The court reasoned that the issue was not that the corporation was in a remote location, but whether there was a good business reason to require the employees to reside on the premises.

- In *J. Grant Farms, Inc. v. Comm'r*,[198] the value of lodging and the cost of utilities provided to a farm manager-sole shareholder and his family was held to be excludable from the manager's income. The court noted that the manager's residence on the farm was necessary and a condition of employment in the swine-raising and grain-drying operation.

- Likewise, in *Johnson v. Comm'r,*[199] a married couple, as the sole shareholders of a corporation, was allowed to exclude from their income the fair rental value of the corporate-owned residence. The residence was located on the premises where the husband was the manager of the corporation's grain drying and storing operation.

- In *Waterfall Farms, Inc. v. Comm'r*,[200] a corporate farming operation rented the residence where the taxpayer (who was a corporate shareholder, officer, and the sole corporate employee) lived. In addition to the lodging, food was provided to the shareholder-employee. The court held that the amounts were not excludable from his income because the corporation could not prove that substantial business activity occurred at the residence. This was the key reason that the court determined that the food and lodging were not provided on the corporation's business premises. The fact that the corporation rented the residence was not material to the business-premises issue.

SUMMARY

Employer-provided meals and lodging are important fringe benefits that employers can provide for their employees. **For owners to obtain the same benefits, they must be provided by a C corporation to an employee.** However, it is important to properly structure such arrangements within the confines of guidelines set forth by the IRS and the courts. Following is a sample corporate resolution that could be used for this purpose.

Sample Corporate Resolution
(Grain Farming)
[with permission from the Iowa Bar Tax Manual]

Whereas, the corporation's employees are required to perform duties which include extended working hours during the crop production cycle, and the duties include a requirement to reside on the corporate farm premises to supervise and secure grain inventory and machinery/equipment of the corporation; and

Whereas, in consideration for those extended hours and on-site duties, the corporation has provided on-premises meals and lodging as a condition of employment within the definitions of IRC §119;

Now, therefore, it is resolved that effective immediately that the corporation shall make its on-premises eating facility available to all of its employees, to allow those employees to attend to their extended duties and on-site supervision requirements.

197. *Dilts v. U.S.,* 845 F. Supp. 1505 (D. Wyo. 1994) (Employee-shareholders of S corporation denied exclusion for both meals and lodging including groceries and utilities).

198. *J. Grant Farms, Inc. v. Comm'r*, TC Memo 1985-174 (Apr. 8, 1985).

199. *Johnson v. Comm'r,* TC Memo 1985-175 (Apr. 8, 1985).

200. *Waterfall Farms, Inc. v. Comm'r*, TC Memo 2003-327 (Nov. 25, 2003).

QUALIFIED FARM INDEBTEDNESS

The recent drop in crop prices has created a financial strain for some agricultural producers. Bankruptcy practitioners report an increase in clients dealing with debt workouts and other bankruptcy-related concerns.

An important part of debt resolution is the income tax consequences to the debtor. Except for installment land contracts and CCC loans, **most farm debt is recourse debt.** That means that the collateral stands as security on the loan. If the collateral is insufficient, the debtor is personally liable on the obligation and the debtor's nonexempt assets are reachable to satisfy any deficiency.

When the debtor gives up property, the income tax consequences involve a 2-step process.

1. It is as if the property is sold to the creditor for FMV, and the sale proceeds are applied to the debt. There is no gain or loss (and no other income tax consequence) up to the income tax basis of the property. The difference between FMV and the income tax basis is gain or loss.
2. If the indebtedness exceeds the property's FMV, the difference is discharge of indebtedness income.

Special rules can minimize the tax impact of discharge of indebtedness income. One of these rules concerns the tax treatment of discharged qualified farm indebtedness. The rule can be a useful tool in dealing with the income tax issues associated with debt forgiveness for farmers that are **not** in bankruptcy.

GENERAL RULES

A debtor should not include in gross income any discharge of indebtedness income if any of the five following conditions are satisfied.[201]

1. The discharge occurs as part of a bankruptcy case.
2. The discharge occurs at a time when the debtor is insolvent.
3. The discharge is **qualified farm indebtedness.**
4. The discharge is qualified real property business indebtedness of a taxpayer other than a C corporation.
5. The discharge is qualified principal residence indebtedness.

> **Note.** For discharged debt that is excluded from income, the taxpayer must complete and file Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment),* with the tax return for the year of the discharge. Form 982 reports the exclusion and any necessary adjustments to the taxpayer's tax attributes.

> **Note.** Only qualified farm indebtedness is discussed in this section. For an explanation of the other types of indebtedness mentioned in the preceding list, see the 2013 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Financial Distress. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

201. IRC §108(a)(1).

Qualified Farm Indebtedness Defined

For farmers, the qualified farm indebtedness rule is of primary importance. It applies to qualified farm indebtedness that is discharged via an agreement between a debtor engaged in the trade or business of farming and a "qualified person." A **qualified person** is defined as a lender that is actively and regularly engaged in the business of lending money and is **not** one of the following.[202]

- Related to the debtor or seller of the property
- A person from whom the taxpayer acquired the property
- A person who receives a fee in connection with the taxpayer's investment in the property

A qualified person also includes federal, state, or local governments or their agencies.[203]

Qualified farm indebtedness is debt that meets two conditions.

1. The debt was incurred directly in connection with the taxpayer's operation of a farming business.[204]
2. At least 50% of the taxpayer's aggregate gross receipts for the three tax years immediately preceding the tax year of the discharge are attributable to the trade or business of farming.[205]

Note. The taxpayer need not be engaged in the trade or business of farming in each of the three prior tax years. However, the Tax Court has held that if the taxpayer is no longer in the trade or business of farming three years before the discharge of a USDA loan, the loan is not qualified farm indebtedness.[206]

Note. To count towards the 50% test, gross receipts must be attributable to the taxpayer's farming activity. If the taxpayer has significant nonfarm income, this can create problems in satisfying the test. Leasing arrangements must also be monitored. A landlord under a cash lease is engaged in a rental activity rather than a farming activity.[207] In addition, the taxpayer bears the burden of proving the 50% test was satisfied.[208]

The exclusion from gross income for qualified farm indebtedness is applied after the insolvency and the bankruptcy exclusions. That means that the qualified farm indebtedness exclusion does not apply to the extent the debtor is insolvent or is in bankruptcy.

Note. For all debtors other than farmers, there is income from discharge of indebtedness if the debtor is solvent, with a possible exception for discharged debt that is associated with the taxpayer's principal residence.

202. IRC §49(a)(1)(D)(iv).

203. IRC §108(g)(1)(B).

204. IRC §108(g)(2)(A).

205. IRC §108(g)(2)(B). Sales of inventory or capital assets count toward the gross receipts test if the sales are attributable to an ongoing or terminating farming activity. See, e.g., *Lawinger v. Comm'r,* 103 TC 428 (1994) (Gross proceeds of farm machinery derived from liquidation sale of farming business count toward the 50% test).

206. *Ngatuvai v. Comm'r,* TC Summ. Op. 2004-143 (Oct. 18, 2004).

207. See, e.g., *Lawinger v. Comm'r,* 103 TC 428 (1994) (In addition, state farmland preservation tax credits received by the taxpayer as a cash-rent landlord did not count towards the 50% test because they were not attributable to a farming operation).

208. *Campell v. Comm'r,* TC Memo 2001-51 (Feb. 28, 2001).

Insolvency. The determination of a taxpayer's solvency is made immediately before the discharge of indebtedness. **Insolvency** is defined as the excess of liabilities over the FMV of the debtor's assets. In addition, both recourse and nonrecourse liabilities are included in the calculation, but contingent liabilities are not.

Both tangible and intangible assets are included in the insolvency calculation. Property exempt from creditors under state law is also included in the insolvency calculation.[209] However, the separate assets of the debtor's spouse are **not** included in determining the extent of the taxpayer's insolvency.

Maximum Amount Discharged. There is a limit on the amount of discharged debt that can be excluded from income under the exception. The excluded amount cannot exceed the sum of the taxpayer's adjusted tax attributes and the aggregate adjusted bases of the taxpayer's depreciable property that the taxpayer holds as of the beginning of the tax year following the year of the discharge.[210]

Reduction of Tax Attributes. The debt that is discharged and that is excluded from the taxpayer's gross income is applied to reduce the debtor's tax attributes.[211] Tax attributes include losses and credits and the basis of certain assets. Unless the taxpayer elects to reduce the basis of depreciable property first, the general order of tax attribute reduction is as follows.[212]

- Net operating losses (NOLs) for the year of discharge as well as NOLs carried over to the discharge year
- General business credit carryovers
- Minimum tax credit
- Capital losses for the year of discharge and capital losses carried over to the year of discharge

Note. Any reductions of NOLs or capital losses and carryovers first occur in the tax year of discharge followed by the tax years in the order from which each carryover arose.[213]

- The basis of the taxpayer's depreciable and nondepreciable assets
- Passive activity loss and credit carryovers
- Foreign tax credit carryovers

Note. The tax attributes are reduced **after** computing tax for the year of discharge.[214] Those attributes that can be carried back to tax years before the year of discharge are accounted for in those carryback years before they are reduced.[215]

The tax attributes are generally reduced on a dollar-for-dollar basis (i.e., one dollar of attribute reduction for every dollar of exclusion).[216] However, any general business credit carryover, the minimum tax credit, the foreign tax credit carryover, and the passive activity loss carryover are reduced by 33.33 cents for every dollar excluded.[217]

209. Ltr. Rul. 9932013 (May 4, 1999), *revoking* Ltr. Rul. 9125010 (Mar. 19, 1991); Tech. Adv. Memo. 9935002 (May 3, 1999); *Carlson v. Comm'r,* 116 TC 87 (2001); *Quartemont v. Comm'r,* TC Summ. Op. 2007-19 (Feb. 6, 2007).

210. IRC §108(g)(3)(A)(ii).

211. IRC §108(b)(1).

212. IRC §108(b)(2); Treas. Reg. §1.108-7(a)(1).

213. IRC §108(b)(4)(B).

214. IRC §108(b)(4)(A).

215. Treas. Reg. §1.108-7(b).

216. IRC §108(b)(3)(A).

217. IRC §108(b)(3)(B).

If the amount of income that is excluded is greater than the taxpayer's tax attributes, the excess is permanently excluded from the debtor's gross income and is of no tax consequence.[218] Alternatively, if the taxpayer's tax attributes are insufficient to offset all the indebtedness discharged, the balance reduces the basis of the debtor's assets as of the beginning of the tax year of discharge.[219]

Discharged debt that would otherwise be applied to reduce basis in accordance with the general attribute reduction rules and that also constitutes qualified farm indebtedness is applied only to reduce the basis of the taxpayer's qualified property.[220] **The basis reduction occurs in the following order.[221]**

1. The basis of qualified property that is depreciable property
2. The basis of qualified property that is land used or held for use in the taxpayer's farming business
3. The basis of other qualified property (any property that is held for use in the taxpayer's trade or business or for the production of income)

Note. The taxpayer can elect to have any portion of the discharged amount applied first to reduce basis in the taxpayer's depreciable property, **including real property that the taxpayer holds as inventory.[222]**

PURCHASE PRICE ADJUSTMENT

A provision related to the qualified farm indebtedness rule for farm debtors is a rule involving a negotiated reduction in the purchase price of property. Under this provision, any negotiated reduction in the contract price of assets does not have to be reported as discharge of indebtedness income.[223] In order to be eligible, the following requirements must be met.

- The debt reduction must involve the original buyer and the original seller.
- The reduction would have otherwise been treated as discharge of indebtedness income to the buyer.[224]
- The reduction does not occur in the context of bankruptcy[225] or when the buyer is insolvent.[226]

Note. The requirement that the purchase price reduction occur between the original buyer and the original seller means that third-party financing cannot be involved.[227] Likewise, a reduction of a credit card balance by the card issuer does not qualify as a purchase price adjustment.[228] The debt must be reduced due to factors that involve direct agreements between the original buyer and seller.

The **buyer** does not have taxable income from a purchase price adjustment. However, the buyer's income tax basis in the property must be reduced by the adjustment amount.

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218. Treas. Reg. §1.108-7(a)(2).
219. IRC §1017(a).
220. IRC §1017(b)(4)(A).
221. IRC §1017(b)(4)(A)(ii).
222. IRC §§108(b)(5)(A) and 1017(b)(3)(E).
223. IRC §108(e)(5)(A).
224. IRC §108(e)(5)(C).
225. IRC §108(e)(5)(B)(i).
226. IRC §108(e)(5)(B)(ii).
227. See, e.g., *Preslar v. Comm'r,* 167 F.3d 1323 (10th Cir. 1999), *rev'g*, TC Memo 1996-543 (Dec. 17, 1996).
228. *Payne v. Comm'r,* TC Memo 2008-66 (Mar. 18, 2008).

For the seller, IRC §453B(a) provides, in part, that if an installment obligation is satisfied at other than its face value or is distributed, transmitted, sold, or otherwise disposed of, gain or loss results to the extent of the difference between the basis of the obligation and:

1. The amount realized, in the case of satisfaction at other than face value or a sale or exchange; or
2. The FMV of the obligation at the time of the distribution, transmission, or disposition, in the case of distribution, transmission, or disposition other than by sale or exchange.

IRC §453B(f) provides that if an installment obligation is canceled or otherwise becomes unenforceable, it is treated as if it were disposed of in a transaction other than a sale or exchange. In addition, if the buyer and seller are related, the FMV of the obligation is treated as not less than its face amount.

However, a purchase price adjustment is a **partial** cancellation. The IRS ruled on multiple occasions that a cancellation of an installment obligation, by itself, is not treated as a disposition.[229] What is impacted is the gross profit ratio that is applied to future installment payments.[230] Thus, the seller does not have immediate adverse tax consequences from the discharge.

LIQUIDITY PLANNING FOR AGRICULTURAL ESTATES

Because of the large estate tax exclusion amount ($5.43 million for deaths in 2015), coupled with the availability of "portability" between spouses, the vast majority of decedents' estates are **not** subject to federal estate tax. However, estates that are subject to this tax can face problems paying the required amount within nine months of death, which is when Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return,* is due.

Farm and ranch estates can face enormous liquidity issues because the largest asset of the estate is typically the land. The liquidity problem has been magnified in recent years because of increasing land values. Sale of farm and ranch assets, such as land, may not be feasible in light of the need to maintain the operation as an efficient operating entity. In addition, the family is often not in favor of selling any piece of the land to pay taxes or for any other reason. From a practical standpoint, it can be difficult to complete a forced sale of farm assets (including land) within nine months of death (a 6-month extension is possible) at a reasonable FMV.

When working with an agricultural estate with illiquid assets, the planner has two significant tools that can minimize the impact of illiquidity. First, an election can be made to value real estate used in farming (or other closely held businesses) at its "current-use" value (subject to a limit) rather than valuing it at FMV at death in accordance with the "highest and best use" valuation standard.[231] **This "special-use value" election reduces the estate tax attributed to the farm or ranch land subject to the election.**

First, a cap is placed on the benefits of special-use valuation that limits the maximum aggregate reduction in the value of qualified real property subject to the election. For deaths in **2015,** the maximum reduction that can be achieved by making a special-use value election is **$1.1 million.**[232] For deaths in **2014,** the maximum reduction is **$1.09 million.**[233]

Second, **an illiquid estate can elect to pay the estate tax that is attributable to the estate's closely held business assets in installments for up to 15 years,** rather than having the entire estate tax due nine months after death.[234]

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229. Rev. Rul. 55-249, 1955-2 CB 252; Rev. Rul. 68-419, 1968-2 CB 196; Rev. Rul. 72-570, 1972-2 CB 241; Ltr. Rul. 8739045 (Jun. 30, 1987).

230. Ibid.

231. IRC §2032A.

232. Rev. Proc. 2013-35, 2013-47 IRB 537.

233. Rev. Proc. 2014-61, 2014-47 IRB 860. When the maximum reduction is applied to qualified real estate that was community property, the limit applies only to the half interest actually included in the decedent's gross estate. Rev. Rul. 83-96, 1983-2 CB 156.

234. IRC §6166.

SPECIAL-USE VALUATION

Under IRC §2032A, an estate may elect to value real property used in farming or other closely held businesses at its **current use for agricultural purposes** rather than at its highest and best use.[235] The provision, however, is very complex, and an estate must have the right set of facts to take advantage of the provision. **Numerous requirements must be satisfied by the decedent for a particular period of time before death, by the estate at the time of death, and by the qualified heir(s) for 10 years after death.**

The following requirements are discussed in this section.

- Requirements for real estate
- Percentage tests
- Qualified-use test
- Material participation test
- Ownership test
- Qualified heir test
- Present-interest test

> **Note.** For the purpose of determining whether the estate qualifies to make a special-use valuation election, transfers made within three years of death are included in the estate.[236]

Requirements for Real Estate

To qualify for the special-use valuation, the real estate must meet the following requirements.[237]

1. Be located in the United States
2. Be acquired from or passed from the decedent to a qualified heir
3. Be used for a qualified use by the decedent or a member of the decedent's family for a certain length of time before death and at the time of the decedent's death

Real estate for this purpose includes roads, buildings, and other structures and improvements functionally related to farming or ranching. A farm residence is eligible real property if it is occupied on a regular basis by the owner, tenant, or an employee of the owner or tenant for the purpose of "operating or maintaining such real property."[238]

Percentage Tests

50% Test. The farming or ranching property (both real and personal) must make up **at least 50%** of the adjusted value of the gross estate, using FMV figures, and at least that amount must pass to qualified heirs.[239] Adjusted value of real or personal property is defined as the FMV less allowable indebtedness attributable to the property. Personal property may be considered in meeting the 50% test only if it is used with the real property that is to be specially valued.

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235. Special-use valuation is also available for timber property if the election is made on an identifiable area of land. IRC §2032A(e)(13). Standing timber is treated as real estate for this purpose, rather than as a crop.

236. IRC §§2035(c)(1) and (2).

237. IRC §2032A(b)(1). Because a "member of the family" can meet the qualified-use test pre-death, the decedent, as a landlord, could have either a crop/livestock share lease or a cash lease with a member of the family.

238. IRC §2032A(e)(3).

239. IRC §2032A(b)(3)(A).

25% Test. A second pre-death requirement is that the farmland itself must make up **at least 25%** of the adjusted value (FMV less allowable indebtedness) of the gross estate.[240] At least 25% of the adjusted value of the decedent's gross estate must be qualified farm real property that was acquired or passed from the decedent to a qualified heir. As such, the land itself must be a significant part of the total value of the estate.

Note. The special-use valuation need **not** be applied to property that constitutes at least 25% of the adjusted value of the gross estate.[241] The 25% requirement only serves to qualify an estate for the special-valuation election. This allows the election to be applied to only the land that is most likely to allow the qualified heir(s) to satisfy the post-death requirements and avoid the recapture tax.

Note. The interest of the decedent's surviving spouse in qualified real property that is held as community property is accounted for to the extent necessary to satisfy the 50% and 25% tests.[242]

Qualified-Use Test

The qualified-use test (sometimes called the equity-interest test) requires the **decedent or family member** to have had an equity interest in the farm operation at each of the following times.[243]

- The time of death
- For five or more of the last eight years before death
- During the 10-year post-death recapture period

Note. A cash-rent lease does **not** produce an equity interest and is not a qualified use in the pre-death period except to a member of the family or family-owned entity as farm tenant.[244] The qualified-use test requires that the decedent or a family member bear the risks of production and the risks of price change. A landlord under a cash-rent lease does not bear the risks of production or the risks of price change.[245]

Material-Participation Test

This test requires active involvement in the farm or ranch business by the decedent or a member of the decedent's family during five or more of the last eight years before the earlier of the decedent's retirement, disability, or death. Surviving spouses, however, only have to provide active management.[246] A surviving spouse of a decedent that satisfied the 5-out-of-8-year test is treated as ordinarily participating if the surviving spouse actively manages the farm or is retired or becomes disabled.[247]

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240. IRC §2032A(b)(1)(B).

241. *Finfrock v. U.S.,* 860 F.Supp.2d 651 (C.D. Ill. 2012) (Treas. Reg. §20.2032A-8(a)(2) invalid insofar as it attempts to impose a nonstatutory requirement that 25% of the adjusted value of the gross estate must consist of farmland subject to the special-use valuation election).

242. IRC §2032A(e)(10).

243. IRC §§2032A(a)(1) and (b)(1)(C).

244. However, a cash-rent lease with a rent adjustment clause can satisfy the test. See, e.g., *Schuneman v. U.S.,* 783 F.2d 694 (7th Cir. 1986) (Amount of rent varied based on crop prices and production levels).

245. Participation in federal farm programs involving the idling of land (such as the CRP) has raised questions concerning whether the qualified-use test can be met on the idled land. Based on several IRS rulings in the late 1980s, it appears that an estate can still satisfy the qualified-use test with respect to land idled under a federal farm program.

246. IRC §§2032A(b)(1)(C)(ii) and (b)(5)(A).

247. IRC §2032A(b)(5)(A).

The test can be satisfied through a crop-share lease with a great deal of involvement, a custom farming operation, or with a direct farming operation. However, a cash-rent lease with the usual minimal involvement in management cannot be used to satisfy the test; nor can it be met with a nonmaterial participation crop-share lease.

In the years before the decedent's death, the decedent or a family member (including an agent such as a farm manager who is also a family member) must be quite active in making decisions. The material participation test is the principal means of excluding inactive investors from eligibility for special-use valuation. Under the statute, **material participation** is determined in a manner similar to that used for SE tax purposes.[248]

Caution. If SE taxes were not paid, material participation is presumed to not have occurred. In that situation, the regulations specify that the executor bears the burden of showing that the decedent materially participated and the reason SE taxes were not paid.[249]

Example 9. Doug, a single elderly grain farmer/landowner, actively farmed his 520 acres for over 50 years. Doug terminated his active farming operation in January 2008 due to failing health. Doug's three children decided to let the oldest sibling, Kurt, make all necessary farm-related decisions beginning in January 2008.

Kurt had a 50/50 crop-share lease with a neighboring tenant farmer during 2008 through 2012, a 5-year period. During 2008 through 2012, Kurt received an annual farm-manager stipend of $2,000. Kurt reported the stipend on his Schedules C for 2008, 2009, 2010, 2011, and 2012 and paid SE taxes for those five years.

Beginning in 2013, Kurt decided to cash rent his father's farm for $325 per acre to the same tenant farmer. The 2-year cash-rent lease period began on March 1, 2013 and terminated on February 28, 2015. The cash rent and related expenses were divided among the three siblings and these amounts were reported on the 2013 and 2014 Schedules E of Kurt and his two siblings. No SE taxes were paid by Kurt and his two siblings on their 2013 and 2014 tax returns.

Doug died on January 10, 2015. His three children inherited an undivided one-third interest in the 520 acres.

Question. Is Doug's estate eligible to use IRC §2032A in order to value his 520 acres at the lower agricultural-use value rather than the higher FMV?

Answer. No. That is true even if the 50% and 25% tests were met by Doug's estate. **A qualified heir did not meet the qualified-use test for the farmland at the time of Doug's death in 2015.** The farm was rented on a cash-rent basis at that time.

Note. If Kurt had maintained the 50/50 crop-share lease during 2013 and 2014 and paid SE taxes in those years on his $2,000 stipend, Doug's estate would be eligible to use IRC §2032A assuming all other requirements were met. Because Doug retired beginning in 2008, the material-participation test began in 2008. In that situation, Kurt, a qualified heir, would have made substantial farm management decisions and paid SE taxes in the 7-year period beginning with Doug's retirement (2008 through 2014). Consequently, Doug's estate would then meet the required material-participation test.

248. IRC §2032A(e)(6).

249. Treas. Reg. §20.2032A-3(e).

If material participation is to be established under a crop share or livestock share lease, the lease should be carefully drafted to show involvement in decision making sufficient to meet the material-participation requirement.

Note. The lease should be in writing and contain provisions requiring landowner involvement in the following types of decisions.

- Cropping patterns and rotations
- Fertilization levels
- Participation (or nonparticipation) in federal farm programs
- Plans for insect and weed control
- Soil and water conservation practices
- Building, fence, and tile line repairs
- Use of storage facilities
- Crop marketing strategies
- Tillage practices
- Seed varieties to be purchased
- For livestock leases, the type of livestock to be produced, marketing strategies, and animal health plans

In addition, the activity under the lease should be substantial enough so that whoever is responsible for meeting the test reports the income under the lease as SE income and pays SE tax on it.

If the decedent (or family member) was an employee, the material participation test is satisfied if the decedent (or family member) was employed for at least 35 hours per week.[250]

Ownership Test

The real estate must have been owned by the decedent or a member of the family and held for a qualified use during five or more years in the 8-year period ending with the decedent's death.

Qualified-Heir Test

As noted earlier, the 50% test requires that the farmland and farm personal property must make up at least 50% of the adjusted value of the decedent's gross estate. In addition, at least this amount must pass to the qualified heir(s) instead of being sold at death.

Note. To satisfy this test, it may be necessary to delay the sale of some of the farm or ranch personal property until after the estate is closed or to obtain a court order for partial distribution of property from the estate to the qualified heirs if an early sale is desired.

250. Ibid.

A qualified heir must be a "member of the family" who acquired the property (or to whom the property passed) from the decedent. The statutory definition of **member of the family** depends upon whether the appropriate measuring period is the pre-death period or the post-death recapture period. This is the case because the term "member of the family" is utilized in special-use valuation to determine:

1. Who can be a qualified heir,
2. Who can provide material participation before death,
3. Who can meet the ownership and qualified-use tests before death,
4. Who can provide material participation to avoid recapture after death, and
5. Who can acquire qualified real property after death from a qualified heir without triggering recapture.

In the **pre-death period,** who qualifies as a member of the family is determined in accordance with their relationship to the decedent. **After death,** who qualifies as a member of the family is determined in accordance with their relationship to the qualified heir. Thus, it is important to keep in mind the importance of the **"base person."** Although a uniform set of rules is used to determine who is a family member, the base person depends upon the particular eligibility period. Before death, the decedent is the base person. After death, it is the qualified heir. A member of the base person's family includes the following.

- All ancestors
- The spouse
- Lineal descendants
- Lineal descendants of the spouse
- Lineal descendants of the parents
- The spouse of any lineal descendant

All of these persons are members of the family and can be qualified heirs.

Present-Interest Test

Elected property is deemed to pass to a qualified heir only if the qualified heir receives a present interest in the property.[251] With respect to life estate/remainder arrangements, the IRS's position is that if there is any possibility that the property could pass to a nonfamily member, then the test is not satisfied. Several cases, however, have tempered such a harsh requirement.[252]

Additionally, when elected property is left in trust for the life of a beneficiary and the beneficiary has the authority to distribute income, eligibility is preserved as long as the income beneficiaries are all family members. Thus, property can be left in a discretionary trust when all of the beneficiaries are family members.

> **Note.** For elected land owned by a corporation, the transfer of stock in a corporation that has a history of no dividend payments and that severely restricts stock transfers might constitute the transfer of a future interest rather than a present interest.

> **Note.** Each person with an interest in the elected property must sign a written consent to personal liability for a special recapture tax set forth in IRC §2032A(c). This consent agreement is filed with Schedule A-1 of Form 706 during the Notice of Election.

251. Treas. Reg. §20.2032A-3(b)(1) (1981).

252. See, e.g., *Estate of Davis v. Comm'r,* 86 TC 1156 (1986); *Estate of Clinard v. Comm'r,* 86 TC 1180 (1986); *Estate of Pliske v. Comm'r,* TC Memo 1986-310 (Jul. 24, 1986); *Estate of Thompson v. Comm'r,* 864 F.2d 1128 (4th Cir. 1989).

Rules for Partnerships and Corporations

For land owned by a partnership to qualify for special-use valuation, the decedent must have had an interest in a closely held business.[253] To qualify as a closely held business, 20% or more of the partnership's total capital interest must be included in the decedent's estate or the partnership must have had 45 or fewer partners.

A similar rule applies to corporations.[254] To qualify as a closely held business, 20% or more of the corporation's **voting** stock must be included in the decedent's estate or the corporation must have had 45 or fewer shareholders.

In addition, the **50% test** (discussed earlier) must be satisfied, as determined by "looking through" the entity to determine ownership. Farm real estate and/or farm personal property must equal 50% or more of the gross estate less secured indebtedness and must pass to qualified heirs.

The farmland that the entity owns must also satisfy the **qualified-use test** (discussed earlier). For entities, all nonfarm property must be carved out. Only the equity interest in the partnership or corporation is eligible for special-use valuation.[255]

Calculating Special-Use Value

There are two methods that may be used to calculate valuation. The **rent capitalization** method is the most commonly used approach.[256] Alternatively, the **5-factor formula** approach may be used.[257] As mentioned earlier, the special-use value election cannot reduce the gross estate of decedents dying in 2015 by more than $1.1 million ($1.09 million for decedents dying in 2014).

Rent Capitalization Approach. This approach uses the following formula.

1. The average annual gross cash rent per acre minus property tax on comparable land, divided by
2. The average annual effective Farm Credit Bank (FCB) interest rate for the last five years. (The IRS annually publishes — usually in August or September — the FCB interest rates for each FCB district.[258])

Each of these average annual computations is made on the basis of the **five most recent calendar years** ending before the decedent's death.

The numerator (item 1) of the formula is determined by obtaining cash-rent figures on **comparable land.** Thus, the estate looks for cash-rented land that is comparable to the decedent's land and obtains from those tracts the cash rent and the property tax amounts.

253. IRC §§ 2032A(g) and 6166(b)(1)(B).

254. IRC §§ 2032A(g) and 6166(b)(1)(C).

255. See Ltr. Rul. 9220006 (Jan. 29, 1992) (Land represented by preferred stock eligible for special-use valuation).

256. IRC §2032A(e)(7).

257. IRC §2032A(e)(8).

258. For deaths in 2014, the FCB interest rates and districts were specified in Tables 1 and 2 of Rev. Rul. 2014-21, 2014-34 IRB 381.

Example 10. Rufus died in 2014 with a taxable estate valued at $10.25 million. Rufus's estate included 750 acres of Illinois farmland with an FMV of $7 million at the date of death. The executor located tracts comparable to the land in Rufus's estate and determined that the comparable tracts cash rented for an average of $300 per acre. Also, the property tax on the comparable tracts averaged $25 per acre. According to the rent capitalization approach, the special-use value of the farmland in Rufus's estate is calculated as follows.

$$\frac{\text{\$300 average gross rent per acre} - \text{\$25 average property tax per acre}}{\text{.0471 average FCB interest rate}} = \text{\$5,839}$$

The election results in the 750 acres being valued at $5,839 per acre in Rufus's estate, or $4,379,250. However, for deaths in 2014, the aggregate reduction in value via the election is limited to $1.09 million. That means that the 750 acres are valued in Rufus's estate for federal estate tax purposes at $5.91 million ($7 million – $1.09 million).

Treas. Reg. §20.2032A-4(d) lists the following 10 factors that are used to determine what constitutes "comparable" land.

1. Productivity indexes that take into account soil properties and weather conditions as the major influences on yield potential
2. Whether soil-depleting crops were grown equally on the tracts being compared
3. Soil-conservation practices used on the tracts
4. Flooding possibilities
5. Slope of the land
6. Carrying capacity for livestock, when appropriate
7. Comparability of timber, if any
8. Whether the tracts are unified or separate
9. The number, type, and condition of buildings as those factors affect "efficient management and use of property and value per se"
10. Availability and type of transportation facilities in terms of costs and proximity of the properties to local markets

5-Factor Formula Approach. If the estate can show that there are no comparable cash-rent tracts or if the estate representative elects, another procedure for arriving at the special-use value may be used. This approach uses the following five factors.[259]

1. Capitalization of income
2. Capitalization of rent
3. Assessed value for property tax purposes
4. Comparable sales in the same geographical area but without significant influence from metropolitan or resort areas
5. Any other factor that fairly values the property

259. The Tax Court ruled that the 5-factor approach is available by default if the estate fails to qualify for the rent capitalization approach. *Estate of Wineman v. Comm'r,* TC Memo 2000-193 (Jun. 28, 2000).

This approach can be used for farmland and timberland as well as land used in a nonagricultural business. The rent capitalization approach is restricted to agricultural land. Only the 5-factor approach can be used for nonfarm land. Agricultural real estate can use either approach.

> **Note.** If the 5-factor formula is utilized, each of the five factors could be challenged during an IRS estate tax audit. The 5-factor approach is not frequently used.[260]

Making the Election

The election is made by filing a notice of election with the decedent's timely filed estate tax return. If the estate tax return was not filed on time, the notice of election can be included with the first estate tax return filed after the due date.

In addition, the executor's election of the special-use valuation must be indicated in part 3 of Form 706, which follows.

Form 706 (Rev. 8-2013)

Estate of:	Decedent's social security number

Part 3—Elections by the Executor

Note. For information on electing portability of the decedent's DSUE amount, including how to opt out of the election, see Part 6—Portability of Deceased Spousal Unused Exclusion.
Note. Some of the following elections may require the posting of bonds or liens.

Please check "Yes" or "No" box for each question (see instructions).

			Yes	No
1	Do you elect alternate valuation?	1		
2	Do you elect special-use valuation? If "Yes," you must complete and attach Schedule A-1	2	X	
3	Do you elect to pay the taxes in installments as described in section 6166? If "Yes," you must attach the additional information described in the instructions. **Note. By electing section 6166 installment payments, you may be required to provide security for estate tax deferred under section 6166 and interest in the form of a surety bond or a section 6324A lien.**	3		
4	Do you elect to postpone the part of the taxes due to a reversionary or remainder interest as described in section 6163?	4		

General Information

The estate should also file Schedule A-1 of Form 706 and provide the following items of information listed in Treas. Reg. §20.2032A-8(a)(3).

1. The decedent's name and taxpayer identification number (TIN)
2. The relevant qualified use
3. The items of real property shown on the estate tax return to be specially valued
4. The FMV of the real property to be specially valued and its value based on its qualified use
5. The adjusted value of all real property that is used in a qualified use and that passes from the decedent to a qualified heir
6. The items of personal property shown on the estate tax return that pass from the decedent to a qualified heir and are used in a qualified use
7. The adjusted value of the gross estate
8. The method used in determining the special value based on use
9. Copies of written appraisals of the FMV of real property

260. An example of the 5-factor approach in an agricultural setting can be found in *Estate of Hughan v. Comm'r,* TC Memo 1991-275 (Jun. 17, 1991) (The primary issue for determination was how far from the decedent's property the estate needed to go to find farmland sale prices unaffected by agricultural use).

10. A statement that the decedent and/or a family member owned all specially valued real property for at least five of the eight years immediately preceding the decedent's death

11. Any periods during the 8-year period preceding the decedent's date of death during which the decedent or a family member did not own the property, use it in a qualified use, or materially participate in the operation of the farm

12. The name, address, TIN, and relationship to the decedent of each person taking an interest in each item of specially valued property, and the value of the property interests passing to each such person

13. Affidavits describing the activities constituting material participation and the identity of the material participant(s)

14. A legal description of the specially valued property

The executor must also file a recapture agreement (discussed later).

Note. Once made, the special-use valuation election is irrevocable.[261] The estate can, however, alter the method used to specially value the qualified real property after the election.

Following is a checklist of items that must be completed to make the election.

- Form 706, Schedule A-1
- Election for IRC §2032A
- Filing the notice of election
- Agreement to special valuation (consent (recapture) agreement)
- Affidavit regarding material participation
- Descriptive calculation of special-use value
- Appraisal of qualified real property
- Appraisal of comparable real property

Protective Election. A protective election should be made if the estate is uncertain whether it will qualify for the election by the due date of Form 706. The protective election preserves the possibility of making the special-use valuation election on an amended Form 706.[262]

The protective election allows an automatic 6-month extension from the due date. However, corrective action must be taken within the 6-month extension period by filing an original or amended return containing the protective election and reporting income for all affected years.

Like the regular special-use election, a protective election requires the decedent's name and TIN, a description of the relevant qualified use, and a listing of the items of property used in a qualified use that also pass to qualified heirs.

Note. If a protective election is filed, it must be included with the FMV estate tax return. A protective election cannot be filed that claims the benefits of an actual election.[263]

261. IRC §2032A(d)(1); Treas. Reg. §20.2032A-8(a)(1).

262. Treas. Reg. §20.2032A-8(b).

263. Ltr. Rul. 8421005 (Feb. 26, 1984).

If a protective election is filed and it is later determined that the estate qualifies for special-use valuation, the estate must file an additional notice of election within 60 days after the date of determination. An amended Form 706 and Schedule A-1 should be used for this purpose.

Note. If the election was made and a recapture agreement was submitted but the notice of election or recapture agreement is deficient (e.g., fails to include all the required information and/or signatures), the executor can "perfect" the election within a reasonable time. This period of time cannot exceed 90 days after the executor learns of the deficiencies.[264]

Special Lien

A special estate tax lien is imposed on all qualified farm or closely held business real property for which a special-use value election was made.[265] The lien arises at the time the election is filed and continues until the potential liability for recapture ceases, the qualified heir dies, or the tax benefit is recaptured.[266]

The lien amount equals the adjusted tax difference for the estate (the difference between the estate tax liability if the IRC §2032A election had not been made and the estate tax liability using the §2032A election).[267] **The lien will be released after the expiration of the 10-year recapture period if there is no further potential for liability.[268]**

Note. The lien does not take priority over property taxes, mechanic's liens for repair or improvement of the property, or security interests for the construction or improvement of real property. The lien also does not take priority over loans made for regular production financing, such as raising or harvesting a crop or the raising of livestock.

Recapture Tax

In addition to the numerous requirements that must be satisfied for a decedent's estate to be eligible for special-use valuation, numerous requirements must be satisfied post-death. The 10 years during which these post-death rules must be satisfied is known as the "recapture period." The 10-year recapture period may be extended by up to two years if the qualified heir does not begin the qualified use and material participation for a period of up to two years after the decedent's death.[269] Therefore, estates that elect the special-use valuation are subjected to a 10-year period (after death or after the end of the 2-year grace period) during which they will have to pay back all the tax benefits if any eligibility rule is violated.

At the time the special-use valuation election is made, the executor must file a recapture agreement with the estate tax return that is signed by each person (born and ascertainable) who has an interest (whether or not in possession) in any property subject to the election. The recapture agreement identifies the property subject to the election and denotes the income tax basis of the property for estate tax purposes as the special-use value. This amount also becomes the income tax basis of the property in the hands of the heirs.[270] In the agreement, the qualified heir (or heirs) consents to personal liability in case a disqualifying event occurs during the recapture period.[271] The other parties signing the agreement consent to the collection of any additional estate tax imposed if an event triggers recapture.

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264. IRC §2032A(d)(3).

265. IRC §6324B.

266. CCA 200119053 (Mar. 16, 2001) (Lien not released until determination made that no recapture event has occurred during recapture period).

267. IRC §6324B(d).

268. CCA 200119053 (Mar. 16, 2001).

269. Instructions for Form 706.

270. In *Van Alen v. Comm'r,* TC Memo 2013-235 (Oct. 21, 2013), the court held that the special-use value pegs the income tax basis in the heirs' hands pursuant to IRC §1014(a)(3). The court upheld that value as reported on the recapture agreement against the heirs under the doctrine of consistency.

271. The qualified heir(s) can be discharged from personal liability by furnishing a bond and applying in writing to the Treasury Secretary. IRC §§2032A(c)(5) and 2032A(e)(11).

The recapture tax amount for any interest is the **lowest** of the following.[272]

1. The adjusted tax difference attributable to such interest
2. The excess of the amount realized with respect to the interest over the value based on the use under which the property qualifies (if disposed of by sale or exchange at arm's length)
3. The excess of the property's FMV over the value based on the use under which the property qualifies (if disposed of by other than arm's length)

However, in any event, the recapture tax is limited to the gain on sale. If the property is sold for its FMV and such price has dropped to or below the special-use value, no recapture tax applies. If the elected land is disposed of other than by sale or exchange at arm's length, the excess of FMV over the special-use value is the recaptured amount.

The recapture tax is reported using Form 706-A, *United States Additional Estate Tax Return*. The tax is due six months after either of the following events[273] and is not eligible for deferral under IRC §6166.

- The qualified heir disposes of any interest in qualified real property (other than by a disposition to a family member).
- The qualified heir ceases to use the real property for a qualified use.

Events That Trigger Recapture. Recapture is triggered by any of the following events.

- **Transfer outside the family.** Recapture occurs if a qualified heir disposes of the land to persons other than a family member of the qualified heir during the recapture period (e.g., to an investor or developer).[274] However, exceptions exist for certain like-kind exchanges and the government's exercise of its eminent domain power.[275] In addition, partial dispositions lead to partial recapture.

  However, recapture does not apply to the tax-free transfer of real estate to a partnership or corporation if the following requirements are met.

  - The qualified heir retains the same interest in the partnership or corporate stock as the individual held in the property given up.
  - The firm is a closely held business.
  - The partnership or corporation consents to the recapture tax if a recapture-triggering event occurs.

- **Lack of material participation.** Recapture occurs if the material participation requirements are not met for more than three years in any 8-year period ending after the decedent's death.[276] The qualified heir or a member of the qualified heir's family must maintain material participation during the recapture period. However, **active management** is enough for surviving spouses, full-time students, persons under age 21, and those who are disabled.[277]

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272. IRC §2032A(c)(A).

273. IRC §§2032A(c)(1) and (c)(4).

274. IRC §2032A(c). See, e.g., Ltr. Rul. 9642055 (Jul. 24, 1996) (Qualified heir's sale of elected land was not disqualifying disposition when sale was to lineal descendants of decedent). For timber property that is specially valued, severance of the timber (or any other disposition including the disposition of a right to sever), triggers recapture. IRC §2032A(c)(2)(E).

275. See, e.g., Ltr. Rul. 9604018 (Oct. 30, 1995) (Elected land exchanged for unimproved land held by college and used for farming; no cash or other property used in the exchange). For involuntarily converted elected property, the qualified heir must elect to have all of the proceeds reinvested in real property for the same qualifying use.

276. IRC §2032A(c)(6)(B). Material participation by a spouse can be used to satisfy the participation requirements. Thus, a surviving spouse's estate can use the material participation of the pre-deceased spouse in partial or complete fulfillment of the material participation requirement in the surviving spouse's estate. IRC §2032A(b)(5)(C).

277. Active management involves the making of management decisions for a business other than daily operating decisions, and can be present even though SE tax is not imposed. IRC §2032A(e)(12).

- **Change in use.** Recapture is also triggered if there is a change in the use of the elected property. Just as a sale or other transfer outside the family during the recapture period triggers the recapture tax, the development of the property or a change to any use other than farm use triggers recapture.[278]

- **No qualified use.** The post-death qualified-use test must be satisfied for the entire length of the recapture period, except for a 2-year grace period immediately following death. However, the rental of land on a "net cash basis" by a lineal descendant of the decedent to a member of the family of the lineal descendant does not cause recapture.[279]

Note. The death of the qualified heir does not trigger recapture.[280] The qualified heir's death eliminates the possibility of recapture with respect to the decedent's property. If there are multiple qualified heirs, the interests of surviving qualified heirs are still subject to recapture. For interests devised to qualified heirs in life estate/remainder form, recapture does not end before the expiration of the 10-year recapture period unless the holders of all interests die.

INSTALLMENT PAYMENT OF FEDERAL ESTATE TAX

Federal estate tax that is attributable to a closely held business can be deferred by virtue of an election under IRC §6166. An estate's executor can elect to pay all or a portion of the estate tax attributable to a closely held business in two or more (but not exceeding 10) equal annual installments if the estate qualifies.

The portion of the estate tax attributable to assets used in a qualifying closely held business can be deferred for up to 14 years from the estate tax return due date (in effect, approximately 15 years). Only interest on the unpaid balance is due on the first four anniversary dates after the due date of the estate return. The first tax payment along with interest is due on the fifth anniversary of the return's due date.

Note. The election must be made at the time Form 706 is filed. Late filing of Form 706 invalidates the election. The statute of limitations is suspended for the period during which the estate tax is deferred.[281]

The ability to defer federal estate tax can be a useful tool for estates that have liquidity issues and would have difficulty paying the federal estate tax in full nine months after the date of the decedent's death. The election to pay in installments allows income generated after the decedent's death to be used to assist the estate in satisfying its estate tax liabilities. The election can also allow the heirs to avoid selling assets that they would prefer to retain, as well as eliminating the need for a forced sale of illiquid assets.

278. An easement grant that is a qualified conservation contribution as defined by IRC §170(h) is not treated as a cessation of qualified use. IRC §2032A(c)(8).

279. For this purpose, a legally adopted child is treated the same as a "child of such individual by blood."

280. IRC §2032A(c)(1).

281. IRC §6503(d).

Qualifications

Two eligibility tests must be satisfied for an estate to qualify for installment payment of federal estate tax.

Tier I Test. To meet the tier I test, the decedent must have had one of the following types of interest in a closely held business immediately before their death.

- If the decedent was a shareholder in a corporation, then 20% or more of the corporation's voting stock must be in the estate or the corporation must have 45 or fewer shareholders.[282]
- For partnerships, 20% of all the partnership's total capital interest must be in the estate or the partnership must have 45 or fewer partners.[283]
- The decedent conducted a trade or business as a sole proprietorship.[284]

The estate tax attributable to land held in a revocable living trust is eligible for installment payment if it is a grantor trust.

> **Note.** An estate that owns interests in two or more closely held businesses can aggregate those interests in order to qualify. If 20% or more of the total value of each business is held by the estate, the aggregate of all such holdings is treated as an interest in a single closely held business for purposes of qualification.

In 2006, the IRS clarified that, to be an interest in a trade or business under IRC §6166, a decedent must conduct an active trade or business or must hold an interest in a partnership, LLC, or corporation that itself carries on an active trade or business.[285] In Rev. Rul. 2006-34, the IRS provided the following list of nonexclusive factors used to determine whether a decedent's interest was an active trade or business.

1. The amount of time the decedent (or agents or employees) spent in the business
2. Whether an office was maintained from which the activities were conducted or coordinated and whether regular office hours were maintained
3. The extent to which the decedent was actively involved in finding new tenants and negotiating and executing leases
4. The extent to which the decedent provided landscaping, grounds care, or other services beyond the furnishing of the leased premises
5. The extent to which the decedent personally made, arranged for, or supervised any repairs and maintenance on the property
6. The extent to which the decedent handled tenant repairs and requests

Rented land constitutes an interest in a closely held business only if it is a crop-share lease or a livestock-share lease in which the decedent (or the decedent's agent or employee) was actively involved in decision making.[286] Passive rental arrangements, such as cash-rent leases, are not eligible for installment payments.[287]

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282. IRC §6166(b)(1)(C).
283. IRC §6166(b)(1)(B).
284. IRC §6166(b)(1)(A).
285. Rev. Rul. 2006-34, 2006-1 CB 1171.
286. See, e.g., Ltr. Rul. 8741076 (Jul. 17, 1987).
287. IRC §6166(b)(9)(A).

If the closely held business qualified for installment payments, the deferred tax may be accelerated in certain circumstances. This occurs if the aggregate distributions, sales, or dispositions of assets after the decedent's death are 50% or more of the date-of-death value of the interest.[288]

> **Note.** For assets leased to business entities, the tier I test is applied separately to the business entity and the leased assets.

In a 1996 ruling,[289] the tier I test was satisfied and the estate was allowed to pay the federal estate tax in installments. The decedent owned land outright that was used by a cattle ranching partnership. The partnership was owned two-thirds by the decedent and one-third by the decedent's son. The partnership conducted most of the decedent's cattle ranching business, and the decedent actively participated in all partnership operations. The IRS determined that the decedent was carrying on the cattle ranching business both as a partner and as a sole proprietor. The land was determined essential to the partnership's ranching operation, and the decedent's income from the land was dependent upon the profitability of the cattle ranching enterprise rather than being a fixed amount.

Tier II Test. The interest in the closely held business must exceed 35% of the value of the decedent's adjusted gross estate.[290]

- Corporate stock of any kind (common or preferred) can meet the tier II requirement. (In the tier I test, only the voting stock counts.)
- An interest in a partnership carrying on a business determines whether the tier II test is met.
- An interest in a sole proprietorship counts towards the 35% test.

Rental arrangements that meet the tier I test also meet the tier II test. Thus, assets under an active lease arrangement may be applied toward the 35% amount, but real estate held primarily for investment purposes does not qualify.

> **Note.** Electing special-use valuation under IRC §2032A may decrease the value of the decedent's interest for the purposes of the 35% test under §6166.

Interests in residential buildings and related improvements that are occupied on a regular basis by the owner, tenant, or an employee of the owner or tenant for purposes of operating or maintaining the property can be included in determining whether the 35% requirement is satisfied.[291] However, if the buildings are occupied by someone working off the farm, it is no longer a business asset.

Acreage under the CRP or other federal acreage diversion programs apparently can be considered part of the decedent's trade or business in determining whether the 35% requirement is satisfied.[292]

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288. See, e.g., Ltr. Rul. 9403004 (Oct. 8, 1993) (Cash-rent lease of ranchland to corporation that decedent partly owned). However, in Ltr. Rul. 200321006 (Feb. 12, 2003), IRS ruled that a cash-rent lease of farmland after death did not accelerate deferred estate tax or count against the 50% that would lead to acceleration. IRS ignored the fact that the lessor, a residuary trust, failed to maintain the assets involved as a business.

289. Ltr. Rul. 9635004 (May 15, 1996).

290. IRC §6166(a)(1). The adjusted gross estate is the gross estate reduced by allowable deductions under IRC §§2053 and 2054.

291. IRC §6166(b)(3).

292. See, e.g., Ltr. Rul. 9212001 (Jun. 20, 1991).

Deferred Payments

For the first five years of deferral, only interest must be paid annually.[293] After that 5-year period, the principal must be paid in equal installments, along with interest on the unpaid principal.

> **Note.** Once the election is made, the first installment is paid on or before the date selected by the executor, which cannot be more than five years after the date tax is due.[294]

Security May Be Required

The IRS may require security for the remaining estate tax owed as a condition for making an installment payment election.[295] The estate may elect to provide a performance bond under IRC §6165 or place a lien on the property as required by IRC §6324A. The IRS determines on a case-by-case basis whether an estate is required to provide a bond.

> **Note.** It is rare that a bond will be required because of its cost. The amount of the bond must be equal to the amount of the deferred estate tax plus the deferred interest.[296] Consequently, in many situations, the estate provides the IRS with a lien on the estate's farmland. In that case, the IRS utilizes Form 668-J, *Notice of Federal Estate Tax Lien Under Internal Revenue Laws.*

Special Lien. If farmland is pledged as collateral to secure the IRS lien, the estate must provide a preliminary title report on the property pledged. The report must provide a legal description and reflect any encumbrances on the property. An agreement to the lien under IRC §6324A is filed with the IRS on Form 13925, *Notice of Election of and Agreement To Special Lien in Accordance With Internal Revenue Code Section 6324A and Related Regulations.* All persons with an interest in the designated property (whether or not in possession) described on the lien must sign this form.

The lien is recorded using Form 668-J. The lien attaches and continues for 10 years unless the estate tax is paid or it becomes unenforceable.[297] If the property described on Form 668-J is insufficient to pay the estate tax in full, then any other property that remains attached by the IRC §6324(a) lien and/or the IRC §6321 liens are subject to enforcement action. Distributees of the estate can also be held liable as transferees.[298]

> **Note.** Although the IRS prefers to secure the lien with real property, any property with equity equal to the deferred taxes plus interest that can be expected to survive the deferral period may be designated in the agreement.

293. IRC §6166(f)(1).

294. IRC §6166(a)(3).

295. IRC §6166(k)(1).

296. IRM 5.5.6.6.

297. The lien is not subject to the notice requirement of IRC §6323(a).

298. IRM 5.5.6.6. In fact, recording the lien discharges the executor and/or fiduciary under IRC §2204. See Treas. Reg. §20.2204-3.

Making the Election

The installment election is made on Form 706 by checking the appropriate box in part 3, as shown below.

Form 706 (Rev. 8-2013)

Estate of:	Decedent's social security number

Part 3—Elections by the Executor

Note. For information on electing portability of the decedent's DSUE amount, including how to opt out of the election, see Part 6—Portability of Deceased Spousal Unused Exclusion.
Note. Some of the following elections may require the posting of bonds or liens.

Please check "Yes" or "No" box for each question (see instructions).

			Yes	No
1	Do you elect alternate valuation?	1		
2	Do you elect special-use valuation? If "Yes," you must complete and attach Schedule A-1	2		
3	Do you elect to pay the taxes in installments as described in section 6166? If "Yes," you must attach the additional information described in the instructions. **Note. By electing section 6166 installment payments, you may be required to provide security for estate tax deferred under section 6166 and interest in the form of a surety bond or a section 6324A lien.**	3	X	
4	Do you elect to postpone the part of the taxes due to a reversionary or remainder interest as described in section 6163?	4		

General Information

The estate should attach a notice of election to the Form 706 that contains the following information.[299]

1. The decedent's name and taxpayer identification number (TIN)
2. The amount of tax to be paid in installments
3. The date selected for payment of the first installment
4. The number of annual installments
5. The properties shown on the estate tax return that constitute the closely held business interest
6. The facts that form the basis for a conclusion that the estate qualifies for payment of the estate tax in installments

Note. A late election procedure can be utilized in the case of certain deficiency determinations made after filing the estate tax return.[300] However, the deficiency cannot be due to negligence, intentional disregard of rules and regulations, or fraud.

Acceleration of Deferred Payments

Under certain conditions, an estate may forfeit the ability to make estate tax payments in installments on a deferred basis.[301]

Disposition. The remaining installments become due if:

- A portion of an interest in a closely held business is distributed, sold, exchanged, or otherwise disposed of; or
- Money and other property attributable to the interest is withdrawn from the business; and
- The aggregate of the distributions, sales, exchanges, or other dispositions and withdrawals is at **least 50% of the value of the interest.**[302]

299. Treas. Reg. §20.6166-1(b).
300. IRC §6166(h)(1).
301. IRC §6166(g).
302. IRC §6166(g)(1)(A).

Transfers involving the decedent's interest in a closely held business at the death of the original heir, or at the death of any subsequent transferee, do not accelerate federal estate tax payment if each subsequent transferee is a family member of the transferor. Thus, property can be left at death to a family member without violating the 50% requirement, but property devised to nonfamily members is always included for purposes of the 50% test. Property sold or given away during life, **even to family members,** counts against the 50% test.[303]

Mere changes in organizational form or tax-free exchanges of property do **not** accelerate installment payments. Mortgaging the property in the post-death period does not accelerate the payments if the funds are used to pay refinancing costs and liens.

Cash renting is always considered a disposition. As a result, cash renting assets during the installment payment period must be avoided. Similarly, a dividend payment is a disposition if it involves payment out of pre-death earnings and profits. This is a problem only with large dividend distributions out of earnings and profits that accumulated before the decedent's death.

Filing bankruptcy does not accelerate installment payments. However, if there are any transfers after the bankruptcy filing, they are included in determining whether the 50% threshold is met.

Default. A default in the payment of the installment amounts or interest triggers acceleration of the unpaid installments.

Violation of the Lien. Any violation of a condition set forth in the lien securing repayment of the deferred tax triggers acceleration of the unpaid installments.

Drop in Value. If the value of the property secured by the lien becomes less than the amount of the unpaid deferred taxes plus interest, the IRS may request additional security. If additional security is not provided within 90 days of demand, the remaining installments due are accelerated.

Note. If the estate has undistributed net income in any tax year after the due date for the first installment payment, the estate must pay an amount equal to the undistributed net income in liquidation of the unpaid portion of the federal estate tax otherwise eligible to be paid in installments.[304] See IRC §6166(g)(2)(B) for an explanation of **undistributed net income.**

303. Thus, a sale to family members during the post-death recapture period for purposes of IRC §2032A does not trigger recapture tax, but it causes acceleration of unpaid installment payments.

304. IRC §6166(g)(2).

Calculation

As mentioned earlier, IRC §6166 treatment is available only for the portion of the estate tax relating to the decedent's closely held business interest. For decedents dying in 2015, interest at 2% (compounded daily) is imposed on the deferred estate tax attributable to the first \$1.47 million of taxable estate value attributable to a closely held business.[305] For deaths in 2015, the amount eligible for deferral at the 2% interest rate is the federal estate tax attributable to a closely held business valued between \$5.43 million and \$6.9 million.[306] To determine the amount of estate tax that can be deferred and paid in installments, the total estate tax (reduced by available credits) is multiplied by a fraction equal to the value of the closely held business interest divided by the value of the adjusted gross estate. The deferral amount is illustrated by the following formula.

$$\textbf{Deferral amount} = \textbf{Net estate tax due} \times \frac{\textbf{Value of closely held business interest}}{\textbf{Value of adjusted gross estate}^{307}}$$

> **Caution.** The deferred interest under IRC §6166 is **not** deductible for either federal estate or federal income tax purposes.

Example 11. Dell Granger died in 2015. Dell's estate holds an interest in a closely held business valued at \$6.9 million. The value of Dell's adjusted gross estate (before the marital and/or charitable deduction) is \$10 million. Dell's estate owes estate tax (net of available credits) of \$3.5 million. Dell's estate can defer up to \$2,415,000 of estate tax.

$$\begin{aligned}\textbf{Deferral amount} &= \$3{,}500{,}000 \times \frac{\$6{,}900{,}000}{\$10{,}000{,}000} \\ &= \$2{,}415{,}000\end{aligned}$$

However, a limit of \$588,000 (\$2,705,800 estate tax on \$6.9 million – \$2,117,800 credit for applicable exclusion amount of \$5.43 million for 2015) is applicable to estates of decedents dying in 2015. Therefore, the amount eligible for deferral at the 2% interest rate is \$588,000.

The excess over the 2% portion is subject to interest at 45% of the rate applicable to underpayments of tax.[308]

"Graegin" Loans

Although the interest on taxes deferred under IRC §6166 is not deductible for estate or income tax purposes, an estate may borrow funds to pay the estate tax and deduct the interest payment as a cost of administration under IRC §2053(a)(2). This result is the outcome of the court's holding in *Graegin v. Comm'r.*[309] In order to be deductible, the interest expense must be "actually and necessarily incurred." For example, this would be the case when the estate is composed of illiquid assets and funds must be borrowed to avoid a forced sale.

To bolster the case for deductibility, the note evidencing the loan should be in writing, bear a market rate of interest, be for a specific term, and prohibit prepayment. Furthermore, the estate must demonstrate that the estate needed to borrow funds to meet its obligations.

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305. Rev. Proc. 2014-61, 2014-47 IRB 860 and IRC §6601(j).

306. Interest paid on federal estate tax that is deferred under IRC §6166 is not deductible for either federal estate tax or federal income tax.

307. Under IRC §2035(a), the value of gifts made within three years of death is not included in the value of the adjusted gross estate unless they are included in the gross estate.

308. The interest on estate taxes that are deferred under IRC §6166 is not deductible for either estate or income tax purposes under IRC §2053.

309. *Graegin v. Comm'r,* TC Memo 1988-477 (Sep. 28, 1988).

POST-DEATH SALE OF LIVESTOCK, UNHARVESTED CROPS, AND LAND

When a farmer dies during the growing season, the tax treatment of the crop (for both income and estate tax purposes) is tied to the status of the decedent at the time of death. The key question is whether the decedent was a farmer or a landlord. If the decedent was a landlord, the tax treatment is tied to the type of lease involved and whether any crop rent had accrued but had not yet been received as of the date of the decedent's death.

The decedent may have owned livestock in addition to other farm assets at the time of death. Unique tax issues must be addressed in connection with these assets, particularly for livestock.

BASIS ISSUES AND CHARACTER OF INCOME

General Rule

Under the general rule, property interests that the decedent owned at death are valued for **estate tax purposes** at their FMV as of the date of the decedent's death.[310] For **income tax purposes,** the basis of property in the hands of the decedent's heir or the person otherwise acquiring the property from a decedent is the property's FMV as of the date of the decedent's death.[311] This is generally known as the "stepped-up" basis rule. Because of the stepped-up basis rule, the heir is not subject to tax on any appreciation in the property's value that occurred during the decedent's lifetime.

Property values may have declined as of the date of death. In this situation, the property's basis is still its FMV as of the decedent's date of death. This is sometimes referred to as a "stepped-down" basis.

> **Note.** The Obama administration's fiscal year 2016 budget proposal seeks to eliminate the stepped-up basis rule (with minor exceptions) and increase the top federal estate tax rate from 40% to 45%.[312]

IRD Exception

Income in respect of a decedent (IRD) property does not receive any step-up in basis.[313] IRD is taxable income the taxpayer earned before death that is received after a taxpayer dies. IRD is not included on the decedent's final income tax return because the taxpayer was not eligible to collect the income before death.

The focus is on the **decedent's right or entitlement to the IRD at the time of death.** IRD includes more than just accrued earnings[314] of a cash-basis decedent. IRD does not include the income potential in a decedent's appreciated property, even if that appreciation is attributable to the decedent's efforts. This is because further action, such as a sale, is required for the appreciation to be realized as income. Likewise, farm products grown and harvested before death (and livestock that is raised before death) but sold after death is property of the decedent at the time of death. It is not treated as a right to income at the time of death.

IRD is subject to both income tax and (for large estates) estate tax. Although IRD does not receive a step-up in basis by virtue of being included in the decedent's estate, the IRD recipient is entitled to a deduction for the federal estate tax that is attributable to the IRD. The deduction occurs in the year the income from the IRD property is recognized.[315] The deduction is calculated as the difference between the estate tax with and without the items that generated the IRD.

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310. IRC §2031.

311. IRC §1014(a)(1).

312. *Proposed Tax Changes in President Obama's Fiscal Year 2016 Budget.* Lundeen, Andrew. Feb. 11, 2015. Tax Foundation. [taxfoundation.org/blog/proposed-tax-changes-president-obama-s-fiscal-year-2016-budget] Accessed on Jun. 1, 2015.

313. IRC §691.

314. IRC §691(c). Accrued crop rents are not allocated between the estate and the decedent's final income tax return.

315. IRC §691(c).

The deduction is allowed regardless of whether the IRD item is used to fund a marital deduction for the surviving spouse (in the estate of the first spouse to die). Thus, in larger estates, it may be prudent to fund the marital deduction with IRD items (so that the income tax on the IRD further reduces the spouse's taxable estate) or with property items that are intended to be held by the recipient rather than resold or which have relatively low appreciation.

In *Estate of Peterson v. Comm'r,* the Tax Court set forth four requirements for determining whether post-death sales proceeds are IRD.[316]

1. The decedent entered into a legal agreement regarding the subject matter of the sale.
2. The decedent performed the substantive acts required as preconditions to the sale (i.e., the subject matter of the sale was in a deliverable state on the date of the decedent's death).
3. No economically material contingencies that might have disrupted the sale existed at the time of death.
4. The decedent would have eventually received (actually or constructively) the sale proceeds if he had lived.

The case involves the sale of calves by a decedent's estate. Two-thirds of the calves were deliverable on the date of the decedent's death. The other third were too young to be weaned as of the decedent's death and the decedent's estate had to feed and raise the calves until they were old enough to be delivered. The court held that the proceeds were not IRD because a **significant number** of the calves were not in a deliverable state as of the date of the decedent's death. In addition, the estate's activities with respect to the calves were **substantial and essential.** The Tax Court held that **all** of the above requirements had to be satisfied for the income to be IRD, and the second requirement was not satisfied.

IRD and Farm Lease Income

Classifying income as IRD depends on the status of the decedent at the time of death. The following two questions are relevant.

1. Was the decedent an operating farmer or a farm landlord at the time of death? If the decedent was a farm landlord, the type of lease matters.
2. If the decedent was a farm landlord, was the decedent a materially participating landlord or a nonmaterially participating landlord?

> **Note.** Materially participating farm landlords report their lease income on Schedule F. Cash-lease income is reported on Schedule E. Nonmaterial participation crop-share or livestock-share lease income is reported on Form 4835, *Farm Rental Income and Expenses*.

316. *Estate of Peterson v. Comm'r*, 667 F.2d 675 (8th Cir. 1981).

Operating Farmers and Materially Participating Landlords. For operating farmers (including materially participating farm landlords), unsold livestock, growing crops, and grain inventories are **not** IRD.[317] The rule is the same if the decedent was a landlord under a material-participation lease.[318] These assets are included in the decedent's gross estate and receive a new basis equal to their FMV as of the decedent's date of death under IRC §1014.[319] No allocation is made between the decedent's estate and the decedent's final income tax return.[320] The allocation rules, when applicable, are discussed later.

Note. Crops that a farmer delivers to a cooperative before death do, however, give rise to IRD.[321]

For income tax purposes, all of the crop production expenses incurred by the farmer **before death** are deducted on Schedule F of the decedent's income tax return. At the time of death, the FMV of any growing crop is established in accordance with a formula (as set forth later). That FMV amount is treated as inventory and deducted when the harvested crop is sold. The remaining costs incurred after death are also deducted by the decedent's estate. In many cases, it may be possible to achieve close to a double deduction.

Nonmaterially Participating and Cash-Rent Landlords. If a cash-basis landlord rents out land under a nonmaterial-participation lease, the landlord normally includes the rent in income when the crop share is reduced to cash or a cash equivalent, not when the crop share is first delivered to the landlord. In this situation, a portion of the growing crops or crop shares or livestock that are sold post-death are IRD and a portion are post-death ordinary income to the landlord's estate. This is the result if the crop share is received by the landlord before death but is not reduced to cash until after death, or if the decedent had the right to receive the crop share and the share is delivered to the landlord's estate and subsequently reduced to cash. In essence, an allocation is made with the portion of the proceeds allocable to the pre-death period (in both situations) being IRD in accordance with a formula described in Rev. Rul. 64-289.[322] That formula splits out the IRD and estate income based on the number of days in the rental period before and after death.

Example 12. Bob, a cash-method taxpayer, leased his farm to Sally for one year beginning March 1, 2014. The rental agreement called for Bob to be paid one-third of the crop in cash upon its sale at Bob's direction.

Bob died on July 4, 2014, after too much partying at the BigFoot Band Festival in a nearby town. Bob was alive 126 days of the rental period.

The executor of Bob's estate ordered the crop sold. The executor was paid $42,000, which was one-third of the crop sale amount, on January 15, 2015. The IRD is $14,499 ((126 ÷ 365) × $42,000). The proceeds attributable to the portion of the rent period that runs from the day after death to the end of the rent period is $27,501 ($42,000 − $14,499). This amount is treated as ordinary income earned by Bob's estate after his death.[323]

Note. The $14,499 was earned before Bob's death, but it is not included on Bob's final income tax return. It is included in Bob's estate for federal estate tax purposes, and the recipient is entitled to a deduction for the federal estate tax (if any) that is attributable to it.

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317. Rev. Rul. 58-436, 1958-2 CB 366. See also *Estate of Burnett v. Comm'r*, 2 TC 897 (1943).

318. Rev. Rul. 64-289, 1964-2 CB 173. While the Code and the Regulations are unclear on the issue, it appears that the decedent could achieve material participation through an agent.

319. See, e.g., *Estate of Tompkins v. Comm'r*, 13 TC 1054 (1949). This is the rule for decedents on the cash method. For those on the accrual method, the items are included in the decedent's closing inventory on the final return.

320. Treas. Reg. §20.2031-1(b).

321. Treas. Reg. §1.691(a)-2(b), Ex. 5. See also *Comm'r v. Linde*, 213 F.2d 1 (9th Cir. 1954), *cert. den.,* 348 U.S. 871 (1954).

322. Rev. Rul. 64-289, 1964-2 CB 173. The formula is directed to decedents who were on the cash method and specifies that for decedents dying during the rent period, only the crop (or livestock share) rents attributable to the rent period ending with the decedent's death are IRD.

323. See also *Estate of Davison v. U.S.*, 292 F.2d 937 (Fed. Cl. 1961).

Example 13. On February 4, 2014, Jerry Mander leased his farm to a tenant on a 60/40 crop-share lease (i.e., Jerry gets 40% of the crop and pays for 40% of the expenses). The lease ran from March 1, 2014, through February 28, 2015, and was for the growing of corn and soybeans on Jerry's farm.

Jerry died on July 4, 2014. The tenant harvested the corn on October 15 and sold it later the same day for $135,000. The soybeans were harvested on October 7 and stored. The soybeans were later sold on January 27, 2015, for $40,000.

The allocation formula operates as follows.

- The lease period was for 365 days (March 1, 2014 to February 28, 2015), and Jerry was alive for 126 of those days. Thus, $18,641 ((126 ÷ 365) × $135,000 × 40%) of the amount that the estate received for the corn is IRD.
- The balance of the amount received by the estate is $35,359 (($135,000 × 40%) − $18,641), which is taxable to the estate as ordinary income.
- The entire $16,000 ($40,000 × 40%) that the estate received for the soybeans is taxed to the estate as ordinary income.

Note. If Jerry had died after the crop shares were sold (but before the end of the rental period), the proceeds would have been reported on Jerry's final return. No proration would have been required.

If Jerry had received his crop share in-kind and held it until death, with the heirs selling it after death, the sale proceeds would be allocated between IRD and ordinary income of the estate under the formula described earlier.

Unpaid (accrued) expenses attributable to IRD items are deducted as an expense on Schedule K of Form 706. They are also deducted on the income tax return of the estate when the expense item is paid.

In a 1997 8th Circuit opinion, a landowner leased his farm to his son in exchange for the right to receive 50% of the proceeds from all crop and livestock sales. In the past, the landowner had always reported the sales proceeds as ordinary income. Upon the landowner's death, his right to receive the rent income was fully vested. If he had lived, he would only have needed to wait to receive his income. Thus, the decedent's right to receive the rent income passed to his estate and the rent the estate received was IRD.[324]

Note. In these situations, IRD does not exist until the crop share is sold. However, if the landlord received the crop share and sold it before death, the income realized is includable on the landlord's final return and is not IRD.[325]

IRD results from crop-share rents of a nonmaterially participating landlord that are fed to livestock before the landlord's death if the animals are also owned on shares. If the decedent utilized the livestock as a separate operation from the lease, the in-kind crop-share rents (e.g., hay, grain) are treated as any other asset in the farming operation — included in the decedent's gross estate and entitled to a date-of-death FMV basis.

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324. *Estate of Gavin v. U.S.*, 113 F.3d 802 (8th Cir. 1997).

325. Ibid.

Crop-share rents fed to livestock after the landlord's death are treated as a sale at the time of feeding[326] with an offsetting deduction.

> **Note.** Animals of an active operator or materially participating landlord are entitled to a step-up in basis equal to FMV at the time of the operator's or materially participating landlord's death. However, they do not receive the automatic long-term capital gain treatment if they are sold before the end of the required holding period (24 months for cattle or 12 months for other livestock).[327] Livestock that are held for sale generate ordinary income, less the FMV as of the date of the decedent's death. Livestock that are held for replacement purposes have a tax basis and are depreciable when they are placed in service.

For estate tax returns required to be filed after July 31, 2015, the executor must file with the IRS a statement identifying the value of each interest in the property. A statement must also be provided to each person acquiring any interest in property included in the gross estate.[328]

CHARACTER OF GAIN ON SALE OF UNHARVESTED CROPS

Sale of Grain

Grain that is raised by a farmer and held for sale or for feeding to livestock is inventory in the hands of the farmer. Upon the subsequent sale of the grain, the proceeds are treated as ordinary income for income tax purposes.[329] **However, when a farmer dies with grain in inventory, the heir is entitled to long-term capital gain treatment upon later sale of the grain even if the sale occurs within one year of inheriting the property if the basis in the crops was determined under the IRC §1014 date-of-death FMV rule.[330]**

> **Note.** Ordinary income treatment occurs if the crop was raised on land that is leased to a tenant.[331]

If the decedent operated the farming business in a partnership or corporation and the entity is liquidated upon the decedent's death, the grain that is distributed from the entity may be converted from inventory to a capital asset.[332] However, to get capital asset status in the hands of a partner or shareholder, the partner or shareholder cannot use the grain as inventory in a trade or business.[333] That status is most likely achieved, therefore, when the partner or shareholder does **not** continue in a farming business after the entity's liquidation.

326. Rev. Rul. 75-11, 1975-1 CB 27.
327. Rev. Rul. 75-361, 1975-2 CB 344.
328. IRC §6035.
329. IRC §§61(a)(2) and 63(b).
330. IRC §1223(9).
331. See, e.g., *Bidart Brothers v. U.S.*, 262 F.2d 607 (9th Cir. 1959).
332. See, e.g., *Greenspon v. Comm'r*, 229 F.2d 947 (8th Cir. 1956). The court held that inventory passing to two 50% shareholders upon liquidation of a corporation was a capital asset in the hands of the shareholders.
333. See, e.g., *Baker v. Comm'r*, 248 F.2d 893 (5th Cir. 1957). Partners who used inventory received upon partnership dissolution in a business similar to the partnership's business were treated as receiving ordinary income upon the sale of the inventory.

Sale of Farmland with Unharvested Crop

When farmland with an unharvested crop is sold post-death, the crops are treated as part of the farmland.[334] That means that if the selling price of the combined farmland and the unharvested crop exceeds the property's adjusted basis (including the production expenses attributable to the unharvested crop), the gain is treated as long-term capital gain, regardless of how long the property is held after death.

> **Note.** This means that the amount of gain treated as ordinary income (from the sale of crop after harvest) is eliminated and the amount of capital gain is increased.

Additionally, when farmland with an unharvested crop is sold, the gain attributable to the unharvested crop is **not** subject to SE tax.

Example 14. Guy Wire planted a soybean crop on April 20, 2014. Guy died on May 1, 2014. Guy's estate sold the land with the unharvested soybean crop on it on October 15, 2014, for $1.2 million. The portion of the selling price attributable to the soybean crop was $250,000, and the expenses attributable to the crop were $100,000.

Had the crop been harvested and sold, the net sale price of $150,000 ($250,000 – $100,000) would have been reported on Schedule F, where it would have been subject to SE tax. **However, by having Guy's estate sell the farmland with the unharvested crop, the $150,000 of net crop value is treated as part of the IRC §1231 gain and is not subject to SE tax.**

> **Note.** Loss is disallowed on a sale or exchange between an executor of an estate and a beneficiary of the estate.[335]

Summary Points

- Although the sale of raised crops or livestock in the estate of an active farmer usually triggers ordinary income, the sale by the estate of land with growing crops results in capital gain treatment for the income that is attributable to the crop.[336]
- The same result is achieved when the crops are harvested during the process of liquidating the farming operation and the land is sold. Part of the basis of the unharvested crop at the date of death is allocated to the crop inventory after harvest. The subsequent sale of the post-harvest crop generates ordinary income, less the cost basis assigned.

334. IRC §1231.

335. IRC §267(b)(13). An exception exists for a sale or exchange in satisfaction of a pecuniary bequest.

336. IRC §§268 and 1231(b)(4).

VALUATION OF CROPS AT DEATH

For estate tax valuation purposes, the crop is valued as of the date of death or six months after death if the executor makes an alternate-valuation election.[337] If an alternate-valuation election is made, any increase in value attributable to crop growth during the 6-month alternate-valuation period is not directly included in the gross estate.[338] Instead, the crop rental value (for both date-of-death and alternate-valuation purposes) is allocated between the pre-death and post-death period in accordance with a formula. The formula multiplies the value by a fraction. The numerator of the fraction is the number of days in the part of the rental period that ends with the decedent's date of death, and the denominator is the total number of days in the rental period.

> **Note.** When the crop is later sold (or fed to livestock), the sale proceeds (or the value of the crop on the date of disposition by feeding to livestock) are used in the formula to determine which portion of the crop rental is IRD and which portion is income to the estate.

Several methods can be used to value an unharvested crop. One approach is to determine a value by discounting the crop by the amount of risk involved between the date of death and harvest. The amount of risk is tied to the type of lease involved.

- Alternatively, the crop could be valued by the amount of a loan, secured by the crop, that could have been negotiated as of the date of death.
- The simplest (and least beneficial to the decedent's estate) approach is to prorate the allocation of the crop proceeds between the pre-death and post-death periods. It is this pro-rata approach that the IRS utilizes to address both estate tax and income tax issues involving unharvested crops in a decedent's estate.

State-Level Taxation

Some states have specific rules for handling unharvested crops at death for tax purposes. In Iowa, for example, the Iowa Department of Revenue uses the pro-rata approach. Thus, growing crops owned by a decedent at death are valued via a formula.[339] Under the formula, the cash value of the crop realized upon sale is prorated by attributing a portion of the value to the period before death and a portion to the period after death. The amount attributed to the pre-death period is the value for Iowa inheritance tax purposes. The numerator of the ratio expresses the number of days the decedent lived during the growing season (corn and soybeans), which is considered May 15 through October 15 (153 days). The 153-day period is the denominator. The ratio is multiplied by the number of bushels realized upon harvest with that result multiplied by the local elevator price at the time of maturity. However, if the estate sells the crop within a reasonable time after harvest in an arm's-length transaction, the selling price can be used as the FMV basis. The Iowa regulations provide the following example.[340]

Example 15. Pete lived in Iowa and raised corn and beans. He died on August 15. Pete lived 92 days of the 153-day Iowa growing season. In the fall, the estate harvested 2,000 bushels of corn that were sold to a local elevator for $3.10 per bushel. As a result, the value of the crop for Iowa inheritance tax purposes is $3,728 ((92 pre-death days ÷ 153 growing-season days) × 2,000 bushels × $3.10 price per bushel).[341]

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337. See, e.g., IRC §2032.

338. Compare Ltr. Rul. 7743007 (Jul. 25, 1977) and Ltr. Rul. 7805008 (Oct. 31, 1977).

339. IAC §701-86.11(7).

340. Ibid.

341. The resulting amount can be reduced by harvesting costs. Such reduction does not appear to be mandatory and, if taken, increases the income tax payable because of the resulting increase of IRD.

The Iowa regulations also address the valuation issue if the decedent was a farm landlord with a tenant operating under a cash lease.[342] In that situation, the Iowa inheritance tax value of the crop is determined in accordance with a formula in which the cash rent for the entire rental period is prorated over the entire year. The proration period is the number of days the decedent lived during the rental period, divided by 365 days. The resulting percentage is then applied to the total cash rent for the entire year. The regulation allows a deduction for rent payments made before death and specifies that if such a deduction results in a negative amount, no refund or credit is allowed.[343]

Note. Apparently, crop harvesting costs can be deducted from the value of the crop that results from the use of the formula.

Other states do not have specific procedures for valuing unharvested crops.[344] In those states, the value may be determined by discounting the crop by the amount of risk involved between the date of death and harvest, with the amount of risk tied to the type of lease involved. Alternatively, the crop's value may be tied to the amount of a loan (secured by the crop) that could have been negotiated as of the date of death. There may also be other acceptable methods of arriving at a reasonable value for unharvested crops.

342. IAC §701-86.11(8).

343. Ibid. The regulation also states that the valuation formula is utilized whether the decedent is the landlord or tenant of the property.

344. Conversely, some states not having established procedures for valuing unharvested crops may have rules for valuing mineral interests at death. In Kansas, for example, interests associated with oil and gas leases are treated as tangible personal property. If the interest is large enough, an appraisal is necessary. However, for smaller interests the state may prescribe the valuation approach to be used. For example, in Kansas, with respect to oil leases and royalties, the average annual income from production for the immediate three years before death is multiplied by 3.5. For a gas well, the average annual production for the five years immediately preceding death is multiplied by 10. If no production occurred in the prior five years, valuation can be based on original cost if the gas well was purchased within a reasonable time before death and there has not been activity in the area to cause an increase in value.