Chapter 7: Agricultural Issues and Rural Investments

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Please note. Corrections were made to this workbook through January of 2017. 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 short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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SELF-EMPLOYMENT TAX ON FARMING ACTIVITY OF TRUSTS

IRC §1402(a) defines net earnings from self employment (SE) as "the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss… from any trade or business carried on by a partnership of which he is a member…"

BUSINESS OF A TRUST NOT SUBJECT TO SE TAX

The regulations provide that a trade or business must be carried on by an **individual,** either personally or through agents or employees. The regulations further provide that "Accordingly, income derived from a trade or business carried on by an estate or trust is **not** included in determining the net earnings from self employment of the individual beneficiaries of such estate or trust."[1] Because of this statutory and regulatory language, income derived from a business maintained by a trust (or an estate) is **not** included in determining net SE earnings of the individual beneficiaries.

WHAT IS A TRUST?

Treas. Reg. §301.7701-4(a) defines a trust as an arrangement created by either will or inter vivos (during lifetime) declaration for the purpose of either protecting or conserving property for beneficiaries. When the trust's beneficiaries are the persons who created the trust, the trust is recognized under the Code if it was created for the purpose of protecting or conserving trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them.

Note. Although the Code recognizes entities as trusts if they meet the preceding requirements, the taxation of trusts is determined under Subchapter J. However, a grantor trust under the provisions of IRC §§671-679 is treated as owned directly by the grantor and is termed a **disregarded entity.** Consequently, trust taxation does not apply, and SE tax may apply.

1. Treas. Reg. §1.1402(a)-2(b).

Treas. Reg. §301.7701-4(b) addresses business trusts, describing these as arrangements in which legal title to property is conveyed to trustees for the benefit of beneficiaries, **but which are not classified as trusts for purposes of the Code** because they are not simply arrangements to protect or conserve property for beneficiaries. These trusts are described as being created by the beneficiaries simply as a device to carry on a profit-making business that normally would have been carried on through business organizations that are classified as corporations or partnerships under the Code.

Example 1. Kyle and his wife, Megan, each created a revocable trust during their lifetime, and each trust was funded with farm property. Kyle was a farmer at the time of his death. Upon his death, Megan became the sole trustee of Kyle's trust. Under the terms of Kyle's trust, two new trusts were created: a qualified terminable interest property (QTIP) trust and a credit-shelter bypass trust. The QTIP and the credit-shelter bypass are irrevocable trusts created upon Kyle's death. Megan was named as the sole trustee of the survivor's trust and the sole fiduciary and beneficiary of the QTIP trust and the credit-shelter bypass trust

Megan participated in the operations and the management of the farming activity. She reported the income and the distributions from the irrevocable trusts on her Schedule E, *Supplemental Income and Loss,* where it was not subject to SE tax. She reported income from the survivor's trust as SE income.

Result. In a technical advice memo (TAM),[2] the IRS determined that the QTIP trust and the credit-shelter bypass trust each had a **separate existence.** Thus, the pass-through income from these trusts was excluded from Megan's net SE earnings. The trusts were not found to be business trusts whose separate existence would be ignored under the Code.[3]

Example 2. After Michael died, an irrevocable, testamentary trust went into effect. His surviving widow, Kelsie, and their son, James, were the trustees and beneficiaries of the trust. The trust paid a fee to James for managing the farming operation and a fee to Kelsie for maintaining the farming records. James and Kelsie reported the fees as SE income but did not report the income they received as beneficiaries of the trust as subject to SE tax.

Result. In a TAM,[4] the IRS treated the trust as a **separate entity.** Consequently, the earnings were not subject to SE tax.[5]

Observation. These TAMs suggest that a trust can insulate the beneficiaries from SE tax on an actively conducted farming operation but only if the following two conditions are met.

1. The trust is created to preserve the property for another party or in a testamentary manner that suggests it is not merely an attempt to move business operations into a trust entity (i.e., it is not a business trust).
2. The trustees or other individuals rendering management or other services to the trust are **reasonably compensated** for their services in a manner that is subject to either Federal Insurance Contributions Act (FICA) or SE tax. With respect to this issue, a testamentary trust can serve in much the same manner as an S corporation, when the issue at hand is the reasonableness of fees or compensation to the entity owners who also receive Schedule K-1 income exempt from SE tax.

Note. An individual who receives a distribution from a trust as a beneficiary and is also paid for trade or business services that the individual provides to the trust should be prepared to document that their compensation is reasonable based on what would be paid to a third party for the services.

2. TAM 200305001 (Jul. 24, 2002).

3. However, the IRS noted that there could be an issue of whether the wife, as trustee, received adequate payments for the services she performed for these two trusts. The IRS suggested that the IRS Examination Division determine whether the payments that the wife received were reasonable and in a sufficient amount for the services that she provided to these trusts.

4. TAM 200305002 (Jul. 24, 2002).

5. However, the IRS noted that there could be an issue of whether the wife received adequate payments for her services and whether the son received reasonable and sufficient payments for his management activities.

INDIRECT FARMLAND OWNERSHIP/INVESTMENT STRATEGIES

Farmers who sell farmland (or other real estate) have the option to defer gain under IRC §1031. Most farmers reinvest the proceeds from farmland sales into other farmland or real estate. Recently, federal legislators and the Obama administration discussed limiting the scope and effect of tax-deferred exchanges and made at least one legislative proposal. Accordingly, many taxpayers with agricultural land expressed interest in alternative strategies to avoid gain on the transfer of farm or ranch real estate that is commonly characterized by a low income tax basis. Options available to the farmer include:

- The real estate investment trust (REIT),
- The umbrella partnership REIT (UPREIT), and
- The Delaware statutory trust (DST).

REAL ESTATE INVESTMENT TRUST

A REIT is a company that owns, and in most cases operates, income-producing real estate. A REIT offers an opportunity to invest in a diversified real estate portfolio without management and transaction costs. IRC §856 provides that a REIT is any corporation, trust, or association that essentially acts as an investment agent specializing in real estate and real estate mortgages. Consequently, REITs own many types of commercial real estate as well as agricultural land. In addition, some REITs engage in financing real estate. In early 2016, there were only a few funds that specialized in farmland ownership, typically leasing to farm operators with a targeted annual income return of 3–5%. The unique rules associated with REITs should be examined by taxpayers and tax preparers prior to investing in REIT interests.

> **Note.** REITs were initially authorized by the REIT Act title of the Cigar Excise Tax Extension Act of 1960.[6] The purpose of a REIT is to provide a real estate investment structure similar to what mutual funds provide for investment in stocks. A REIT offers investors the opportunity to invest in large-scale, diversified portfolios of income-producing real estate in the same way they typically can invest in other types of assets.

Basic Tax Rules

A REIT must annually distribute at least 90% of its taxable income to shareholders in the form of dividends.[7] Thus, a REIT can be a strong income vehicle for its shareholders to the extent profits exist. A REIT is also entitled to deduct dividends paid to shareholders. As a result, a REIT often avoids incurring federal income tax liability on all or part of its income. To reduce or eliminate corporate income tax, a REIT must elect REIT tax treatment by filing Form 1120-REIT, *U.S. Income Tax Return for Real Estate Investment Trusts,* and satisfy certain other requirements.[8]

6. PL 86-779 (Sep. 14, 1960).
7. IRC §857(a)(1).
8. IRC §856(c)(1); Treas. Reg. §1.856-2(b).

The key characteristics of a REIT can be summarized as follows.

- Structured as a corporation, trust, or association
- Managed by one or more directors or trustees
- Issues transferable shares or transferable certificates of interest
- Taxable as a domestic corporation
- Not a financial institution or a domestic corporation
- Shares or certificates owned by 100 persons or more (no attribution rules apply)[9]
- 95% of gross income derived from dividends, interest, and property income[10]

> **Note.** Timber gain is included under IRC §631(a) as a category of statutorily recognized qualified real estate income of a REIT if the cutting is provided by a taxable REIT subsidiary and also includes gain recognized under IRC §631(b). The otherwise applicable 1-year holding period does not apply. For sales to a qualified organization for conservation purposes, the holding period is two years under IRC §857(b)(6)(D), which provides a safe harbor from prohibited-transaction treatment for certain timber property sales.

- Pays dividends of at least 90% of the REIT's taxable income (excluding net capital gain)[11]
- No more than 50% of the shares held by five or fewer individuals (attribution rules apply) during the last half of each tax year[12]
- At least 75% of total assets invested in real estate, cash and cash items, and government securities[13]
- Derives at least 75% of its gross income from rents from real property, interest from loans secured by real property or interests in real property, gain from the sale of investment real property, REIT dividends, income from foreclosure property, qualified temporary investment income, and other specified sources[14]
- Maintains the statutorily required records[15]
- No more than 25% of its assets invested in taxable REIT subsidiaries (For tax years beginning after December 31, 2017, no more than 20% of a REIT's assets can be invested in taxable REIT subsidiaries.)[16]

REITs are potentially subject to tax at corporate rates on undistributed REIT taxable income, undistributed net capital gain, income from foreclosure property, the income "shortfall" if they fail to meet the 75% or 95% tests, income from prohibited transactions, and income from redetermined rents. Dividends paid and specified other items are deducted from taxable income.

Shareholders are taxed on REIT ordinary dividends they receive to the extent of the REIT's earnings and profits. In addition, shareholders are taxed on REIT capital gain dividends in the year received as long-term capital gains, regardless of the holding period.[17]

9. IRC §856(h). Under IRC §856(h)(2), this rule does not apply in the REIT's first tax year.
10. IRC §856(c)(2).
11. IRC §857(a)(1)(A).
12. This rule does not apply in the REIT's first year. IRC §856(h)(2).
13. IRC §856(c)(4)(A). For this purpose, "real estate assets" does not include mineral, oil, and gas interests. IRC §856(c)(5)(C).
14. IRC §856(c)(3).
15. IRC §856(k).
16. IRC §856(c)(4)(B)(ii).
17. IRC §857(b)(3)(B).

REITs provide the opportunity to own real estate assets and avoid the transaction and management costs of owning land directly. Purchases can be made in smaller lots, which allows more diversification of ownership.

UMBRELLA PARTNERSHIP REIT

In an UPREIT, instead of the REIT owning property directly, all of the REIT's assets are indirectly owned through an umbrella partnership (the "operating partnership") of the REIT. The REIT directly owns only interests in the operating partnership (the "unit").

Structure

Typically, the REIT contributes cash to the operating partnership in exchange for units. The real estate owners (farmers) contribute properties to the operating partnership in exchange for units that are convertible into REIT shares at the option of the unit-holder at a rate of one unit per REIT share.

Because the contributors transfer their property to a partnership, these contributions are generally tax-free under IRC §721 at the time of the contribution. However, the contributors must recognize any built-in gain in the future if they exercise their right to convert their units into REIT shares.

> **Note.** If there is debt on the property contributed and the amount of debt allocated to the taxpayer decreases, the transaction may result in gain. Usually, the UPREIT allocates the same amount of debt back to the taxpayer as was transferred into the UPREIT. Debt in excess of basis also triggers gain to the contributing partner.

A "lockout" period is usually negotiated as part of the deal structure. This lockout period prevents the UPREIT from selling the contributed property for a certain term. Without this lockout period, the UPREIT could sell the property contributed, which would result in a recognized gain to the taxpayer under IRC §704(c). If the UPREIT sells the property during the lockout period, the UPREIT usually provides an indemnity payment to the taxpayer. The UPREIT is allowed to dispose of the property in a tax-free exchange.

> **Observation.** The UPREIT provides diversification by allowing farmers to pool their farmland or other real estate investments. Several public and private REITS have been formed over the last several years. The use of an UPREIT has allowed taxpayers with large farm real estate holdings to diversify their holdings and provide more liquidity without incurring an immediate tax liability.

DELAWARE STATUTORY TRUSTS

In Rev. Rul. 2004-86,[18] the IRS provided for the creation of a DST to hold real estate. Such a trust is structured as a "security," which allows the taxpayer to purchase an interest in the trust that holds title to the real estate. The investors in a DST share their investment in the real estate.

> **Note.** The key difference between a DST and a tenants-in-common ownership (TIC) is that the DST investor does not directly own real estate. Instead, they hold beneficial interests in a particular form of trust (the DST). This eliminates the need for the investor to be on the deed and sign loan documents.[19]

18. Rev. Rul. 2004-86, 2004-33 IRB 191.

19. Accordingly, lenders do not care about the number of investors in a DST, and the limitation to 35 investors in a TIC arrangement set forth in Rev. Proc. 2002-22 does not apply.

The property sponsors, who are trustees of the DSTs, are national real estate developers who purchase the property and structure it as a securities DST. A written offering document provides very detailed information on tenants and leases, area demographics, financial projections, etc. The annualized income offered by the DST is usually in the 5-7% range, depending on investment opportunities.

Following are some of the **disadvantages** to the DST.

- The pre-packaged trust structure and property management arrangement for the real estate in a DST make this an extremely passive investment to the taxpayer.
- The holding period for these DSTs is normally in the 2–10 year range. Therefore, the taxpayer must "roll over" their investment at a later time.
- Investment returns are usually capped at the 5–7% range. An individual taxpayer who reinvests in other farmland or real estate may be able to generate a greater return on their own.

The **advantages** of a DST compared to a TIC are as follows.

- The investor in a DST generally has greater exit strategies than are available with a TIC arrangement. When the transfer of DST ownership occurs, banks are usually not involved.
- The DST investor has more diversification options during the 45-day identification period under IRC §1031.
- The limitation on 35 investors in a TIC arrangement set forth in Rev. Proc. 2002-22 does not apply. This allows offerings to 100 or more investors, with the minimum investment amounts in a more reasonable range of $100,000 to $250,000.
- The DST itself shields an investor from liability. Therefore, there is no need to set up single member limited liability companies.

ALLOCATIONS FOR CRP CONTRACT CHANGES

Under the typical conservation reserve program (CRP) contract, farmland is placed in the CRP for a 10-year period. Contract extensions are available. The CRP contract requires the landowner to maintain a grass cover on the ground (which may involve planting appropriate wild grasses and other vegetation) and to perform mid-contract maintenance of the enrolled land in accordance with United States Department of Agriculture Farm Service Agency (USDA/FSA) specifications.

It is not unusual for farmland enrolled in the CRP to be sold with several years remaining on the CRP contract. If this occurs, generally the buyer assumes the CRP contract under the existing rates and terms. Another issue arises when crop prices are relatively high and there is an economic incentive to put the CRP-enrolled land back into production. When this occurs, the owner of CRP-enrolled land must reimburse the USDA for **all current and prior-year CRP rents they received**, plus interest and liquidated damages of 25% of the rental payments (which in rare instances might be waived).

> **Note.** Although the early termination payments may be characterized as penalties, such payments are liquidated damages and are deductible. Nondeductible penalties are fines and similar penalties paid to a government for a violation of any law.[20]

20. IRC §162(f).

PURCHASE PRICE ALLOCATION TO CRP CONTRACT

The requirement that an owner of CRP land pay a penalty by reimbursing the USDA for all CRP rents received, plus interest and damages, is analogous to a lessee's termination of a lease when the obligations under the lease exceed the benefits. When a lessee terminates a lease and pays a cancellation fee to do so, the lessee is generally allowed a deduction. The rationale for allowing a deduction is that the lessee does not receive a future benefit, as long as the lease cancellation payment is not integrated in some manner with the acquisition of another property right.[21]

> **Observation.** Although not involved in the CRP situation, when a lessee terminates a lease by buying the leased property, any cancellation fee must be capitalized. This is because IRC §167(c)(2) bars an allocation of a portion of the cost to the leasehold interest. Thus, allocations to lease contracts by purchasers of real estate are not effective. The taxpayer must allocate the entire adjusted basis to the underlying capital asset. For depreciation purposes, a proration of the adjusted basis of property may not be allocated to a leasehold interest. Likewise, the IRC §197 amortization rules hold that any interest under an existing lease may not be treated as amortizable.[22]

SALE PRICE ALLOCATION TO CRP CONTRACT

The IRS ruled that a taxpayer who sold the right to 90% of the revenue from three CRP contracts that had approximately 11 years remaining was required to report the lump-sum payment as ordinary gross income in the year of receipt.[23] The taxpayer agreed to comply with all the provisions of the CRP contract, with damage provisions applying if he failed to comply. The taxpayer reported the entire amount received for the sale on Form 4835, *Farm Rental Income and Expenses,* for the year of sale (Year 3).

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On the following year's return (Year 4), the taxpayer included the annual CRP payment from the remaining 10% on Form 4835 and claimed a deduction for the part that was sold in Year 3. On the next year's return (Year 5), the taxpayer included the total CRP payment and did not offset it with the amount he sold to the buyer. The taxpayer later filed amended returns to remove the amount reported as income on Form 4835 in the year of sale (Year 3) and to remove the expense deduction that was claimed on Year 4's return.

The taxpayer claimed that the lump sum was not income in Year 3 because he did not have the unrestricted right to the funds (due to the damage clause applying in the event of noncompliance) and that he only held them as a conduit. The IRS disagreed, noting that the taxpayer had received the proceeds from the sale of the CRP contracts, with the risk of nonpayment by the USDA shifted to the purchaser. The IRS also stated that amounts received under a claim of right are includable in income, even though the taxpayer may have to repay some portion later. In addition, the IRS noted that a lump-sum payment for the right to future ordinary income generally results in ordinary income in the year of receipt.[24]

The acquiring farmer may pay the early termination costs. In such case, the payment should be considered part of the land cost, as an additional cost incurred to acquire full rights in the property (i.e., a payment made to eliminate an impediment to full use of the property).

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21. If the termination payment is part of a single overall plan involving the acquisition of an affirmative benefit, the taxpayer must capitalize the payment. See Ltr. Rul. 9607016 (Nov. 20, 1995).

22. IRC §197(e)(5)(A).

23. CCA 200519048 (Jan. 27, 2005).

24. See *Cotlow v. Comm'r,* 22 TC 1019 (1954), *aff'd* 228 F.2d 186 (2nd Cir. 1955) (Life insurance agent bought the rights to assigned commissions for renewals of life insurance from other insurance agents and had ordinary income in the year of receipt from those assigned renewal commissions.).

EARLY TERMINATION PAYMENTS

A lessor's payment to the lessee to obtain cancellation of a lease that is not considered an amount paid to renew or renegotiate a lease is treated as a capital expenditure subject to amortization by the lessor.[25] The amortization period depends on the intended use of the property subject to the canceled lease.

If the lessor pays a tenant for early termination to regain possession of the land, the termination costs should be capitalized and amortized over the lease's remaining term.[26] However, if early termination costs are incurred solely to allow the sale of the farm, the seller's costs should be added to the basis of the farmland and deducted as part of the sale.

Early Termination Payments for CRP Contracts

A landlord paying early CRP termination costs to enter into a new lease of farmland with a farmer in order to switch to crop production must capitalize and amortize the costs over the remaining term of the terminated CRP contract.[27] This is the case when a lease cancellation is not tied to substantial improvements that are to be made to the property.[28]

However, the IRS might claim that such costs should be amortized over the term of the **new lease** if the new lease is for a longer period than the remaining term of the CRP contract.[29] The U.S. Court of Appeals for the 9th Circuit has questioned this position, noting that the Tax Court decision that seemed to bolster the IRS position relied on court cases that alternated between using the unexpired lease term and the new lease term.[30] The 9th Circuit cited *Miller v. Comm'r*[31] as establishing the general rule that lease cancellation costs should typically be written off over the unexpired term of the canceled lease.

> **Note.** If the economics of the cancellation fee are primarily tied to below-market rents under the old lease, amortizing the cost over the unexpired term correctly matches the costs to the period benefited.

25. Treas. Reg. §1.263(a)-4(d)(7).

26. Rev. Rul. 71-283, 1971-2 CB 168.

27. *Miller v. Comm'r,* 10 BTA 383 (1928) (Cancellation of a building lease by paying the existing tenant a lump-sum to allow the landlord to enter into a more profitable lease of the same building constituted a capital expenditure that could be deducted proportionately over the life of the unexpired term of the canceled lease.).

28. *Handlery Hotels, Inc. v. U.S.,* 663 F.2d 892 (9th Cir.1981) (Lessor allowed to amortize the payment for cancellation of the old lease over the term of the old lease instead of the new lease's longer term. This was because the shorter amortization period more accurately reflected income insomuch as the cost of the cancellation was directly related to lessor regaining the old leasehold.).

29. *Montgomery v. Comm'r,* 54 TC 986 (1970).

30. *Handlery Hotels, Inc. v. U.S.,* 663 F.2d 892 (9th Cir. 1981).

31. *Miller v. Comm'r,* 10 BTA 383 (1928).

FARM TILE TAX ISSUES

Drainage of farmland is a very important issue for agricultural producers. The use of global positioning systems by farmers makes it much easier to target wet spots in fields that could benefit the most from appropriate drainage. Drainage can speed planting time, enhance the growing season, and boost production. Drainage may also positively affect the underlying value of the land and any associated rental value.

ECONOMICS OF TILING

The economic benefit of tile drainage depends on numerous factors including the type of crop being drained, the cost to install the drainage, and annual costs for maintenance.

Observation. Based on Land Grant University research, many types of field crops benefit from drainage. This is particularly the case with crops grown on lower-quality soil that was previously poorly drained. Typical yield increases due to drainage improvements are likely in the 10 to 15% range.[32] Yield increases due to drainage improvements can range from 10 to 45 bushels per acre for corn and 4 to 15 bushels per acre for soybeans. In dollar terms, research also indicates that for Midwest **corn** ground, the per acre reduction due to inadequate drainage ranges from $50 to $150. For **soybeans,** the per acre reduction ranges from $30 to $100.

These potential losses make poorly, or less than completely, drained acres less productive and, therefore, less desirable to rent. These values also indicate that poorly drained fields should rent for less than well-drained areas because the fields cannot produce higher yields and income.

Rental Contracts and Payment Options When Adding Tile

Two key issues are who pays for the tiling and how does the rental contract agreement between the tenant and the landlord change.

1. **Tenant and landlord split cost of tiling**

   The tenant and the landlord split the cost of the tiling. The tenant pays for the tile and the landlord pays for the installation. They enter into a long-term rental contract (7 to 10 years). Base rent is comparable to what well-tiled land is renting for. The tenant and the landlord utilize tax depreciation for the amount of cost each incurred. The tenant completes repairs on the tile until the initial agreement expires. If the land is sold prior to the end of the initial rental contract, the landlord pays the tenant for the amount of any undepreciated tile using an economic (not tax) depreciation method.

2. **Tenant pays for tiling costs**

   The tenant pays for all initial tiling costs. The tenant and landlord enter into a long-term contract (7 to 10 years). The tenant pays rent based on untiled rental value, obtains a long-term lease, and benefits from higher production to recover the tiling cost. The landlord now has higher valued land without any cash investment. When the contract expires, rent then is determined based on the amount paid on comparable land with similar tiling. If the land is sold during the contract period, the landlord must repay the tenant for the amount of tiling cost remaining. Following the completion of the contract, the landlord owes nothing to the tenant on the tile if the land is sold. The tenant receives all tax depreciation for the tile cost, including IRC §179 expensing, bonus, and regular depreciation.

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32. Scholt, Linda Rue, *Effects of drainage water management in Southeast Iowa.* (2015) Graduate theses and dissertations paper 14863.

3. **Cash rent — landlord pays tiling costs**

   The landlord pays for all tiling costs. Base cash rent is increased to a level comparable with tiled land. The landlord increases per acre returns to recover the investment and may not have any long-term restrictions. The tenant benefits from higher production, which offsets the higher rent, and has better quality soil conditions. The landlord takes all tax depreciation but is limited to using only regular or bonus depreciation.

4. **Crop share — landlord pays tiling costs**

   For share rents, the landlord pays the same percentage of the tiling costs as that reflected in the crop-sharing arrangement. The tenant does the same. Under other arrangements, the landlord pays all the cost and benefits from the tax deduction, increased land values, and increased crop-share income. If the tenant pays any tiling cost, a long-term lease should be established with buyout provisions for the tenant if the land is sold prior to the end of the lease. Each party deducts their portion of any tiling costs paid. Under a crop-share arrangement, the landlord is eligible to use the §179 deduction.

DEPRECIATION-RELATED ISSUES

Farm drainage tile is depreciable as 15-year property.[33] As farm property, it can be depreciated at a rate up to 150% declining balance.

Tile is also eligible for IRC §179 depreciation irrespective of whether the tile is new or used if it is purchased for use in the active conduct of a trade or business.[34] Although normally a lessor who is treated as the owner of the property for federal tax purposes is eligible to claim IRC §179 depreciation on the property, a lessor who merely holds the property for the production of income is not eligible.[35] Farm drainage tile rented under a cash rent lease is generally considered ineligible for IRC §179 depreciation because it is being used in a rental activity rather than in the active conduct of a farming business. Thus, landlords that pay for drainage tile installed on the leased property cannot use §179 depreciation unless the tile is used in the landlord's trade or business of farming, which requires a share-rent lease.

A noncorporate lessor taxpayer is only eligible for the IRC §179 depreciation if:

- The taxpayer manufactures or produces the leased property, or
- The property lease term (including renewal options) is less than half of the modified accelerated cost recovery system (MACRS) class life of the leased property. In addition, for the first 12 months after the property is transferred to the lessee, the deductions for trade or business expenses under IRC §162 that the lessor could claim for the property (other than rental payments and reimbursed expenses) must exceed 15% of the rental income that the property produces.[36]

Note. In *Thomann v. Comm'r,*[37] the Tax Court held that a sole-proprietor farmer's oral leases were for an indefinite period. Thus, the lease terms were not less than half the MACRS class life of the leased property (which included drainage tile) and the property was not eligible for IRC §179.

Observation. To satisfy the noncorporate lessor rule, the lease term must be for less than 7½ years including renewal options.[38] The 15% test for business expenses may be difficult to pass.

33. IRS Pub. 225, *Farmer's Tax Guide.*
34. IRC §179(d)(1)(C).
35. Treas. Reg. §1.179-1(i)(1).
36. IRC §179(d)(5)(B).
37. *Thomann v. Comm'r,* TC Memo 2010-241 (Nov. 1, 2010).
38. IRC §179(d)(5)(B).

If the tenant pays for the drainage tile, is deemed the owner of the tile for tax purposes, and uses the drainage tile in the tenant's farming business, the tenant can claim §179 depreciation on the tile and depreciate any amount not claimed under §179 over 15 years. New tiling costs also qualify for bonus depreciation.

The tenant must own the tile for the length of the lease agreement to claim §179 depreciation. **This should be clearly specified in a written lease.** The lease should also contain a landlord repayment clause that addresses the situation in which the lease is terminated early and the tenant has paid the tiling cost. Any repayment should be based on the lease period rather than the tax period. Similarly, if the tenant pays for the tile and is depreciating it over the term of the lease, an early termination of the lease could require the tenant to recapture depreciation deductions. This can result in a loss of tax benefits for the tenant.

> **Note.** If the landlord pays for the tile, the tax basis for the land increases when tile is installed and then declines as the tile is depreciated. If the landlord does not pay for the tile, the income tax basis for the land does not change.

Upon termination of the lease or completion of the lease term, the landlord generally owns the tile. In addition, some states may have rules that apply to relatively longer term leases. It is important for the parties to the lease to be familiar with these unique state law requirements.

FARM LOSS DEDUCTIBILITY LIMITATIONS

Low crop prices in recent months have increased the possibility that farming operations will sustain losses. Farm operating losses that are not covered by crop insurance are fully deductible if certain rules are satisfied. Those rules include:

- The at-risk rules under IRC §465,
- The passive loss rules under IRC §469, and
- The excess farm loss rule under IRC §461(j).

THE AT-RISK RULE

For farming operations that are organized as S corporations or are unincorporated, the deductible loss for the year is limited to the amount that the farmer has at risk in the farming business. A farmer is generally considered to be at risk for the amount of money and basis in property that the farmer contributes to the farming operation and the farm debt for which the farmer is personally liable.

PASSIVE LOSS RULE

Farm income is classified as either active or passive. The classification is determined based on the farmer's level of participation in the farming activity. If the farmer's participation satisfies one of several material participation tests, the income from the farming activity is not passive, and resulting losses from the activity are fully deductible. Otherwise, the loss is limited for tax purposes to the extent of the farmer's passive income from other sources.

> **Note.** For more information about the at-risk rules and the passive loss rules, see the 2016 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: S Corporation Shareholder Issues. For further information about the passive loss rules and a detailed explanation of the material participation tests, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Passive Activities. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

EXCESS FARM LOSS RULE

Effective for tax years beginning after 2009, farming operations that have received "applicable subsidies" are subject to an overall limitation on farming losses. This applies to farming operations that are not C corporations. This limitation is the greater of:

- $300,000 ($150,000 in the case of a farmer filing as married filing separately), or
- Aggregate net farm income over the previous 5-year period.[39]

> **Note.** Excess farm losses that are disallowed can be carried forward to the next tax year and treated as a deduction in that year.

The definition of **applicable subsidy** is contained in section 15351 of Public Law 110-234 (the 2008 Farm Bill). That provision amended IRC §461 by adding subsection (j), with the definition of the term contained in subsection (j)(3). IRC §461(j)(3) reads as follows.

For purposes of this subsection, the term "applicable subsidy" means —

a. *any direct or counter-cyclical payment under title I of the Food, Conservation, and Energy Act of 2008 [the 2008 Farm Bill], or any payment elected to be received in lieu of any such payment, or*

b. *any Commodity Credit Corporation loan.*

The 2014 Farm Bill created price loss coverage (PLC) and agricultural risk coverage (ARC), while at the same time repealing direct payments and counter-cyclical payments and continuing loan deficiency payments (LDPs) through 2018. However, the 2014 Farm Bill did not modify IRC §461 even though the subsidies referred to in IRC §461(j)(3)(A) were repealed. This leaves only commodity credit corporation (CCC) loans as currently within the definition of "applicable subsidy" for purposes of the excess farm loss rule. The instructions to Schedule F, *Profit or Loss From Farming,* only reference CCC loans for the excess farm loss rule.

> **Observation.** An LDP is a direct payment made to a producer for a commodity when the producer has a beneficial interest in a commodity in lieu of a marketing assistance loan. This applies when the CCC-determined value, which is based on the current local price in a county, is below the applicable county loan rate. The payment is the difference between the two amounts multiplied by the eligible quantity.

HANDLING FARM LOSSES ON THE RETURN

Deductible farming losses (i.e., those not limited by the at-risk rule, the passive loss rule, or the excess farm loss rule) can be used to reduce taxable income for prior or future tax years. **Generally, a farming net operating loss can be carried back five years or carried forward 20 years.** However, a farm taxpayer can irrevocably elect to carry back a farming loss two years or irrevocably elect to waive the entire carryback period. If the entire carryback period is waived, the loss is carried forward until utilized but not more than 20 years.

> **Observation.** The choice of carrying back the loss first to the fifth preceding year or the second preceding year or forgoing the entire carryback period depends upon the relative tax brackets of the earlier years versus the expected tax brackets of the future years. If the benefit of using the 5-year carryback is small compared to the benefit of the normal 2-year carryback, then the election should be made to forgo the 5-year carryback on the return in the year of loss but accept the 2-year carryback. Farm losses carried to other years do not reduce self-employment (SE) tax liability.

The tax practitioner must ensure that farming losses are properly handled on the return. However, because of the more narrow definition of excess farm losses contained in the 2014 Farm Bill, there is a diminished chance that the excess farm loss limitation rule applies to farming operations that are not C corporations.

39. IRC §461(j).

EMPLOYMENT OF CHILDREN IN A FAMILY FARM BUSINESS

In many family farm businesses, the children of the business owner render services that can be reasonably compensated. These wages produce a business deduction to the farm employer and may result in zero tax to the recipient child.

> **Observation.** The business deduction saves the sole proprietor employer both federal income and SE tax, which could be nearly 40%. For a wage payment of $6,000, the potential tax benefit could be as much as $2,400.

EARNED INCOME OF DEPENDENT CHILDREN

The standard deduction of a dependent child is allowed in full against the child's earned income. Therefore, for 2015 and 2016, a child's wages and other earned income up to $6,300 are exempt from federal income tax.

> **Note. Earned income** includes salaries and wages that are subject to FICA, as well as wages statutorily exempt from FICA (e.g., compensation paid by a proprietor to a child **under age 18).**[40] It also includes commodity wages exempt from FICA under IRC §3121(a)(8)(A). The kiddie tax, potentially affecting the unearned income of those under age 24, **does not** apply to earned income.

Parental Employment Age Requirements

No FICA tax is imposed on the wages of a child under age 18 for services provided in the employ of a parent, such as when the parent conducts a proprietorship that engages the child's services.[41] FICA tax also does not apply to wages paid to a child under age 21 for in-home domestic services while employed by a parent.[42]

> **Caution.** To be exempt from FICA tax, the employer must be a sole proprietorship or a partnership or LLC taxed as a partnership in which the parents are the only partners. If the employer is a C corporation, S corporation, or LLC taxed as a corporation, FICA tax must be paid.

Funding a Roth IRA

Although a parent cannot deduct wages paid to their child for in-home domestic services, the earned income received by the child is generally not subject to income tax if it is less than the standard deduction amount. However, this earned income allows the child to fund a Roth IRA.

40. IRC §3121(b)(3)(A).

41. Ibid.

42. IRC §3121(b)(3)(B).

Example 3. Al is a farm proprietor. He employs his son, Tim, for four years for various farm duties and summer work while Tim is in high school. Tim's wages are not subject to FICA, because he is under age 18 and employed by a parent. Tim invests $2,000 of his compensation in a Roth IRA for the first year of his employment, $3,000 for the second year, and $4,000 each for the third and fourth years (total of $13,000). When Tim graduates from high school and enters college, his Roth IRA has grown from $13,000 to $16,000 ($3,000 of total earnings).

Tim has several options available with respect to his IRA.

- He could withdraw the entire $16,000, in which case the $3,000 of earnings is reportable on Tim's return as ordinary income. However, the $3,000 is exempt from the 10% early-withdrawal penalty, if all the funds are expended on Tim's higher education costs.[43] Kiddie tax would likely be imposed on the $3,000 if Tim is a full-time student under age 24.

> **Note.** For a detailed explanation of the kiddie tax, see the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 5: Special Taxpayers. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

- He could withdraw the $13,000 of basis tax-free and continue to defer the $3,000 of earnings. When he eventually acquires his first residence, he could withdraw up to $10,000 that would not be subject to income tax or the 10% early-withdrawal penalty.[44]
- He could allow the undistributed earnings and the principal to continue to grow for his retirement.

> **Note.** For more information about Roth IRAs, see the 2016 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: Retirement.

FUNDING COLLEGE

Many farmers are in a unique position to fund their children's college education in a tax-efficient manner. In addition to paying children under age 18 cash wages, cash-method farm proprietors and partners can make gifts of unsold grain. Incorporated farm businesses can pay compensation with in-kind grain sales for services rendered by the owner's children.

The taxable income generated by these commodity sales (even if subject to the kiddie tax) and compensation amounts reported on the child's return can in turn be offset by education credits. If the child's dependency exemption is claimed on the parents' return, any education credit (i.e., the American opportunity credit (AOC) or lifetime learning credit) must be claimed on the parents' return. However, the parents can elect to not claim the child's dependency exemption so the child can claim the education credit on their own return.[45] The election to forgo the child's dependency exemption may be beneficial to higher-income parents who are subject to the phaseout of personal exemptions. The parent's election to forgo the child's dependency exemption does not shift the exemption to the child. The child remains ineligible for the exemption.[46]

43. IRC §72(t)(2)(E).

44. IRC §72(t)(2)(F).

45. Treas. Reg. §1.25A-1(f).

46. IRC §151(d)(2).

The Protecting Americans from Tax Hikes Act of 2015 made the AOC permanent. The credit is available for the first four years of college and provides a maximum tax credit of $2,500 (100% of the first $2,000 of tuition and related expenses and 25% of the next $2,000 of tuition and related expenses). Forty percent of the AOC is refundable, unless the taxpayer is subject to the kiddie tax. The AOC phases out for married filing jointly (MFJ) taxpayers with a modified adjusted gross income (MAGI) of $160,000–$180,000 and for single, head of household, and qualifying widow(er) taxpayers with a MAGI of $80,000–$90,000.[47] This phase-out range is not adjusted for inflation.

The lifetime learning credit is a nonrefundable credit calculated as 20% of the first $10,000 of qualified education expenses, resulting in a maximum credit of $2,000 per year.[48]

> **Note.** For detailed information about the AOC and lifetime learning credit, see the 2015 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: Education.

Example 4. Bob, a farmer in the 25% tax bracket, has a daughter, Beth, who was a college freshman in the fall of 2015. Because Beth did not provide over half of her own support and because she is a student under age 24, she can be claimed as a dependent on Bob's return. However, he elects to forgo Beth's dependency exemption on his tax return. As a result, Beth can claim either the AOC or lifetime learning credit on her federal income tax return.

In 2015, Beth has $6,000 of ordinary income from wages and $15,100 of short-term capital gain from the sale of grain received as a gift from Bob. The family's tax advisor determines that Beth should claim the AOC. Her education expenses were over $4,000, so she qualifies for the maximum AOC of $2,500.

A summary of Beth's 2015 Form 1040 follows.

Wages	$ 6,000
Short-term gain on grain sales	15,100
AGI	$21,100
Less: 2015 standard deduction	(6,300)
Less: personal exemption	(0)
Taxable income	$14,800
Income tax (including the kiddie tax of $3,250)	$ 3,430 [a]
Less: AOC	(2,500)
Net tax	$ 930 [b]

[a] The kiddie tax is computed by taking the 25% income tax rate applicable to Bob and multiplying it by $13,000 (($15,100 short-term gain on the sale of grain − $2,100 kiddie tax exemption) × 25% = $3,250 kiddie tax). The remaining taxable income of $1,800 ($14,800 taxable income − $13,000) is subject to tax at the child's tax rate, which is assumed to be 10%. Therefore, the total tax is $3,430 (($13,000 × 25%) + ($1,800 × 10%)).

[b] The tax preparer should analyze the effect on both the parents' and child's returns to determine the combined family tax savings.

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47. IRC §25A(i)(4).

48. IRC §25A(c)(1).

SPOUSAL EMPLOYMENT AND COMMODITY WAGES

For agricultural labor, only cash wages are subject to social security tax. Wages paid in-kind for agricultural labor are not subject to social security and Medicare tax (FICA), FUTA (Federal Unemployment Tax Act), or income tax withholding. However, wages paid in-kind are subject to income tax.[49] Payment in the form of grain, soybeans, cotton, or other commodities usually qualifies for the exemption. There are issues associated with payments in the form of livestock or livestock products but, with careful attention to the rules, such payments should qualify for the special treatment for wages paid in kind. Payments in a form equivalent to cash are ineligible for the in-kind wage treatment.

ADVANTAGES OF SPOUSAL COMPENSATION ARRANGEMENTS

Salaries that farm proprietors pay to spousal employees in commodities reduce net income and SE tax by removing income from Schedule F, *Profit or Loss From Farming*. In addition, a proprietor's employment of the spouse can allow the employer-proprietorship to provide tax-free fringe benefits that are fully deductible for income tax and SE tax purposes (such as medical insurance and a health reimbursement arrangement).

Further, wages paid to a spousal employee or use of an **optional method of calculating SE** earnings can create "earned income," which could result in a refundable earned income credit (EIC).

For 2016, a farmer can use the optional method of reporting SE income if their gross farm income does not exceed $7,560 or their net farm profit is less than $5,457. Using the optional method benefits low-income farmers by allowing them to report more than their actual net earnings as SE income. The result is greater credit towards future social security benefits by paying more SE tax. The optional method allows a farmer to calculate SE earnings as the lesser of two-thirds of gross farm income (not less than zero) or $5,040. Unlike a nonfarm taxpayer who can use the optional method five times during their life, there is **no limit** on the number of years that a qualified farmer can use the optional method.[50]

> **Example 5.** Mack is a sole-proprietor farmer. He files joint tax returns with his wife, Millie. They have two small dependent children.
>
> In 2016, Mack anticipates gross farm income of $160,000, but expects the Schedule F to report a loss. Millie provides services to the farming business and could be paid a reasonable salary of $9,500. Neither Mack nor Millie have any additional income.
>
> Their tax preparer, Hilda, advises Mack to pay Millie $9,500 of wages and to elect the optional method of reporting SE income. Therefore Mack's 2016 SE income is $5,040 and their refundable 2016 EIC is $5,572. This produces a 2016 federal tax refund of $4,801 ($5,572 EIC − $771 optional SE tax).
>
> If Millie's $9,500 salary is paid in cash, Mack's 2016 payroll tax return will report a FICA tax liability of $1,453 ($9,500 × 15.3% FICA rate). If Millie's compensation is paid in commodities, FICA tax liability is avoided.

STRUCTURING AGRICULTURAL NONCASH WAGES

Under the regulations, remuneration for agricultural labor paid in a medium other than cash is generally excluded from wages for FICA, FUTA, and federal income tax withholding purposes. For agricultural labor, this results in various noncash payments being excluded from wages subject to these taxes, including lodging, food, clothing, car tokens, transportation passes or tickets, farm products, or other goods or commodities.[51]

49. IRC §§3121(a)(8)(A), 3306(b)(11) and 3401(a)(2); Treas. Reg. §31.3121(a)(8)-1(b).

50. *If You Are Self-Employed.* 2016. Social Security Administration. [www.ssa.gov/pubs/EN-05-10022.pdf] Accessed on May 17, 2016.

51. Treas. Reg. §31.3121(a)(8)-1(f).

Noncash agricultural wages are subject to employment taxes if the substance of the transaction is a cash payment.[52] Whether noncash agricultural labor payments are equivalent to cash payments has become a contentious issue. The "substance over form" analysis is inherently factual, and each case should be evaluated on its own facts.[53]

For in-kind wage payments to be exempt from FICA, FUTA, and income tax withholding, the employee must exercise dominion and control over the payment (e.g., making the decision when to sell the commodity). In 1994, an IRS Task Force produced guidelines that set forth several other factors that may be relevant in determining whether a particular in-kind payment qualifies for the exemption.[54] These factors include the following.

1. Whether the commodity is properly identified
2. Whether there is documentation of the transfer of the item
3. Whether the payment is intended to be a substitute for cash (Payments in the form of negotiable warehouse receipts, generic commodity certificates, and deferred payment contracts are likely considered as equivalent to cash.)
4. Whether the employee negotiated the subsequent sale of the commodity
5. Whether the employee bore the risk of loss (or gain) for the commodity after the wage payments
6. Whether the employee bore the cost of ownership (e.g., storage, feeding, insurance, and maintenance costs)
7. The time interval between the employee's receipt of the in-kind payment and the employee's subsequent conversion of that payment into cash

Note. The commodities should either be produced in the employer's trade or business or acquired for use in the trade or business. The commodities should not be sold back to the employer. Expenses associated with commodities appear to be treated as employee business expenses subject to the 2% floor for miscellaneous itemized deductions.

A typical in-kind wage payment transaction should include the following elements.

- The employer and employee enter into an employment contract calling for the payment of wages in kind.
- The employer properly makes the wage payment in actual commodities.

Note. According to the IRS Task Force guidelines, the wage payment triggers income recognition for the employer as though the commodities were sold, with an equal offsetting wage deduction for the amount paid to the employee.

- The fair market value (FMV) of the commodity on the transfer date is reported on the employee's Form W-2, *Wage and Tax Statement,* but with no income tax withheld. Furthermore, the amount of the commodity wage is not included as wages for FICA or FUTA tax reporting. Thus, the commodity wage is reported in box 1 ("wages, tips, other compensation") for income tax purposes but is not included in social security and Medicare wages reported in boxes 3 and 5, respectively.
- The employee reports the FMV of the commodity as wage income for income tax purposes. This gives the commodity an income tax basis.

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

53. *Farmers ATG — Chapter 9: Treatment of Noncash Wages.* Rev. May 2011. IRS. [www.irs.gov/business/small-business-self-employed/farmers-atg-chapter-nine-employment-] Accessed on Aug. 8. 2016.

54. *Farmers ATG — Chapter 7: General Livestock.* Rev. May 2011. IRS. [irs.gov/businesses/small-businesses-self-employed/farmers-atg-chapter-seven-general-livestock#appendixc01_01] Accessed on May 18, 2016.

- Any gain or loss on a subsequent sale is reported as capital gain or loss on the employee's Form 8949, *Sales and Other Dispositions of Capital Assets* (which flows to Schedule D, *Capital Gains and Losses)*. However, if the employee is independently involved in the trade or business of producing the commodity, the sale is reported on Schedule F.
- Carrying costs associated with the commodity, such as storage or marketing costs, can be reported on the employee's Schedule A, *Itemized Deductions,* as miscellaneous itemized deductions subject to the 2% of adjusted gross income (AGI) threshold.

The following examples illustrate proper and improper ways to structure in-kind wage payment arrangements.

Example 6. Hamilton is an employee of a family-owned farm corporation. Some of his compensation is paid in cash, and he receives additional compensation of 20% of butcher hogs at market weight. This results in a payment of $6,000 in cash and $34,941 in hogs in one year and $11,000 in cash and $41,272 in hogs in the next year.

When the corporation's butcher hogs were ready for market, 80% of the hogs were allocated to the corporation and 20% to Hamilton. On some occasions, Hamilton's hogs were sold at the same time as the corporation's hogs. The buyer wrote a separate check to each party.

Result. In Ltr. Rul. 9322003 (Feb. 25, 1993), the IRS ruled that, under similar facts, all compensation was considered equivalent to the payment of cash. In addition, the IRS determined that the employment contract was structured to eliminate the FICA taxes on a substantial portion of the employee's compensation.

Note. This ruling was issued before the IRS Task Force produced the 1994 report. A transaction structured like this may now be permissible under the Task Force guidelines.

Example 7. Bob Jones is the sole shareholder of a farming corporation. The corporation pays him in grain that is not segregated from the corporation's grain but instead is stored in the corporation's grain bins. Bob does not pay the corporation for storing the grain.

Result. In Ltr. Rul. 9403001 (Aug. 17, 1993), under similar facts, the IRS ruled that the wages paid in the form of grain were subject to FICA taxes.

Note. This ruling came out before the 1994 Task Force guidelines, but it might still fail to qualify as exempt under the tests of the 1994 report.

Example 8. Kellogg is the president of a family-owned farm corporation. He and his wife, Poppy, are the sole shareholders of the corporation. Kellogg is also an employee and is compensated with a percentage of the annual corn and soybean production. He waited a relatively short time to sell the commodities.

Result. Under the 1994 Task Force guidelines, all the relevant factors must be reviewed. In 1994 (but before the publication of the guidelines), the IRS ruled that the transaction was in substance a payment of cash, constituting wages for FICA purposes.[55] In the ruling, the IRS noted that the employee and spouse were the sole shareholders and were therefore able to control the form of compensation paid.

Note. Although the 1994 IRS Tax Force guidelines acknowledge that noncash wages are not subject to FICA, FUTA, and federal income tax withholding, they provide a fairly **narrow interpretation** of IRC §3121(a)(8)(A). **Since the guidelines are not binding, taxpayers can choose to not follow them, but they are more likely to be challenged in an IRS audit if they do not follow the guidelines.**

55. Ltr. Rul. 9428003 (Apr. 5, 1994).

Example 9. Michelle Smith is employed as a herd manager on a dairy farm. Part of her compensation is paid in milk and meat that her family consumes.

Result. In 1982 (well before the issuance of the Task Force guidelines), the IRS ruled, under similar circumstances, that the remuneration paid in farm products was not cash wages and was therefore not subject to FICA taxes.[56]

Currently, such a determination is based on the facts and circumstances. For payments of milk, the central issue is whether the employee **establishes dominion and control** over the employee's portion of the milk. In some situations, an arrangement is made with the purchaser of the milk to treat every fifth or tenth shipment, for example, as the employee's milk.

Example 10. J.C. Biggs owns and operates a livestock farm. He also works part time for his neighbor. At the end of each month, J.C. is paid three bushels of corn for every hour of work in accordance with the employment agreement. J.C. transports the grain to his farm and places it in his grain bins from which he feeds his own livestock.

Result. The commodity wages appear to satisfy all of the IRS Task Force factors. Again, a facts and circumstances test is applied.

Example 11. John Whyne has incorporated his farrow-to-finish hog operation, and employs his daughter, Jane. The corporation compensates Jane with five slaughter hogs for each month she works on the farm. Each month Jane's hogs are marked and placed in a pen with the corporation's hogs. When the corporation decides to sell hogs, Jane's hogs are marketed with the corporation's hogs and Jane receives a check from the packing company for her hogs.

Result. The IRS may likely challenge this arrangement because Jane **does not have dominion and control** over her hogs and does not independently decide when to market them.

Observation. A better arrangement would require Jane to pay a reasonable daily fee to care for her hogs and to independently market them.

Example 12. Porkie Farming Corporation made payments of hogs to two officers as bonus compensation for labor performed for Porkie. The hogs transferred to them were scheduled to be sold by Porkie shortly after the transfer. The officers did not market the hogs separately from Porkie. Instead, the hogs were transported to market and sold in the same batch as Porkie's hogs and sold to the same buyer on the same terms.

Result. In a case involving these facts,[57] the court held that the transfer of the hogs to the officers was a disguised cash transfer with the sole purpose of tax avoidance.

Note. Wages paid in-kind do not count as W-2 wages for purposes of the 50% of wages limitation for the domestic production activities deduction.[58]

56. Ltr. Rul. 8252018 (Sep. 17, 1982).

57. *Highway Farms, Inc. v. U.S.,* No. 4-00-cv-80606 (S.D. Iowa Feb. 1, 2002).

58. IRC §199.

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General Observations

Following are some important observations about paying agricultural wages in-kind.

1. When wages are paid in-kind, it is highly advisable to have a written compensation agreement specifying the employee's duties and the rate and form of payment for the employee's services. The contract should specify payments in terms of commodities rather than in cash terms satisfied with commodities.

   - The contract, whether written or oral, should state the rate of payment in units of the commodity or other noncash compensation. A written contract is preferable. It should specify that there is an employer-employee relationship and state the quantity or percentage of the commodity that will be paid to the employee in exchange for the labor.

   - If the grain is stored in the employer's bin until the employee sells the commodity, the employment contract should either specify that rent-free use of the bin is part of the employee's compensation or the rental rate should be structured so that the employee pays for the use of the bin.

   - If there are expenses associated with marketing the commodity, the employee should pay those expenses. When the employee sells the commodity, the sale proceeds should not be deposited in the account that is used to pay farm expenses.

2. Careful handling of the commodity and separate accounts for the proceeds are necessary to show the employee's dominion and control over the noncash wages.

3. The source of the commodity should be a commodity raised or produced by the employer instead of a commodity specifically purchased to accomplish employee compensation in-kind.

4. The period that the employee holds the commodity (from the date the employer transferred the commodity to the employee's sale date) is subject to IRS scrutiny. The longer the holding period, the less risk of an IRS challenge.

5. The employee must actually receive ownership of the commodity from the employer before any sale. This establishes that the employee has complete control and bears all risks associated with marketing and selling the commodity.

Note. Related to this point, the employee's commodity should not be resold to the employer. In addition, there should not be a loan from the employer to be satisfied by the disposition of the commodity.

6. It is more difficult to pay noncash wages with livestock than it is with grain because livestock require more care from the time that the noncash wages are paid to the employee to the date that the employee sells the livestock. To show dominion and control of the livestock, it is important that the employee decide how and where the livestock are fed and housed. However, when an employee shows that **dominion and control** is present by taking care of the livestock, any gain the employee realizes on the sale of the livestock runs the risk of incurring SE tax if the practice is conducted with regularity over an extended period.

7. The payment of in-kind wages may threaten an agricultural employee's eligibility for social security disability benefits and may reduce or eliminate the employee's social security retirement benefits. Agricultural employees receiving wages in-kind do not build up retirement or disability credit under the social security system.

Observation. For this reason, many employers agree to pay part of the wages in cash and part in kind. An employee receives credit for the cash portion of wages for purposes of the quarters of coverage needed for disability and retirement benefits.

8. Payments in-kind for agricultural labor are not considered wages for purposes of determining the earnings limit when the employee begins receiving social security benefits.

Caution. An employee is potentially subject to SE tax if, after receiving the commodity from the employer, the employee uses the commodity to produce other grain or to conduct a business. However, such exposure is limited to the appreciation of the commodity after receipt, because the employee has tax basis equal to FMV at the date of the transfer.

To assist clients in maintaining a proper record of commodity transfers, the following worksheet may be helpful.

Farm Commodity Payment Worksheet

Year: ______________
Employer: ______________
Employee: ______________
Terms of compensation for current year: ______________________________

To Be Completed by EMPLOYER:	To Be Completed by EMPLOYEE:
I. COMPUTATION OF QUANTITY TO BE PAID Annual production ________ Percentage to be paid (per agreement) × ________ Quantity to be paid to employee ________ II. RECORD OF PAYMENTS TO EMPLOYEE: **Balance** Quantity to be received (per computation above) ________ Plus: carryover of unpaid balance from previous year ________ Less: overpayment from previous year (________) Adjusted quantity (to record payments against below)	**SALE DATA** Please provide a copy of this worksheet to your employee at year-end. Record below the subsequent sale of the commodities received.

Date	Value of Commodity On Date of Transfer	Quantity Transferred

Total value for year: $ ________ (Reported on W-2)

Date	Quantity	Sale Amount	Expense Reimbursed to Employer

Total: $ ________

Note. It is important that the commodity transfer be documented and occur at least several weeks before the employee sells the commodity. Any unpaid quantity and any overpayment should be carried over to the next year. The commodity should not be sold back to the employer.

AGRICULTURAL FINANCING ISSUES

Economic conditions for many farmers have deteriorated over the past two years. Prices for many crops have dropped, livestock prices have decreased from recent highs, and cash rents and land values have leveled off or fallen. In some instances, agricultural producers leveraged to expand their operations during the good times, only to find that the tougher farm economy has made things financially difficult.

In a downturn, legal and tax issues become critically important for many farmers and ranchers. One of these issues — the distinction between capital leases and operating leases—is vital to understand so that unexpected negative consequences can be avoided.

CAPITAL LEASE VS. OPERATING LEASE

A **capital lease** is a lease in which the lessor's sole task is to finance the "leased" asset, and all other rights of ownership transfer to the lessee. Conversely, with an **operating lease,** the asset owner (lessor) transfers only the right to use the property to the lessee. Ownership is not transferred as it is with a capital lease, and possession of the property reverts to the lessor at the end of the lease term. As a result, if the transaction is a capital lease, the asset is the lessee's property and, for accounting purposes, is recorded as a fixed asset in the lessee's general ledger. For tax purposes, the lessee deducts the interest portion of the capital lease payment as an expense, rather than the amount of the entire lease payment (which is allowed for an operating lease).

There are some important reasons that capital and operating leases must be properly characterized. One is that leases can be kept off a lessee's financial statements, which could provide a misleading picture of the lessee's finances. Another reason involves the proper tax characterization of the transaction. With an operating lease, the lessee deducts the lease payment as an operating expense and there is no impact on the lessee's balance sheet. With a capital lease, however, the lessee recognizes the leased property as an asset and the lease payments as a liability on the balance sheet. Additionally, with a capital lease, the lessee claims an annual amount for depreciation and deducts the interest expense associated with the lease. Based on these distinctions, many businesses prefer to treat lease transactions as operating leases, even when the structure of the transaction indicates that they should not.

According to the Financial Accounting Standards Board,[59] a transaction is a capital lease if it meets **any one** of the following conditions.

- Ownership of the asset shifts to the lessee by the end of the lease period.
- The lessee can buy the asset from the lessor at the end of the lease term for a below-market price.
- The lease term is at least 75% of the estimated economic life of the asset (and the lease cannot be canceled during that time).
- The present value of the minimum lease payments required under the lease is at least 90% of the fair value of the asset at the time the lease is entered into.

Note. For a capital lease, the present value of all lease payments is considered the asset's cost which, as mentioned previously, the lessee records as a fixed asset, with an offsetting credit to a capital lease liability account. For accounting purposes, as each lease payment is made, the lessee records a reduction in the capital lease liability account and a charge to interest expense. The lessee records a periodic depreciation charge to reduce the carrying amount of the fixed asset in its accounting records. The lessor has revenue equal to the present value of the future cash flows from the lease and records the expenses associated with the lease. The lessor records a lease receivable on their balance sheet and recognizes the interest income as it is paid.

59. *Statement of Financial Accounting Standards No. 13*. Nov. 1976. Financial Accounting Standards Board. [www.fasb.org/resources/ccurl/62/358/fas13.pdf] Accessed on Jun. 29, 2016.

If none of the above conditions are satisfied, the transaction is an operating lease. In that event, the lessee can deduct each lease payment as a business expense, and the lessee does not treat the leased asset as an asset.

In a typical agricultural situation, a farmer "trades in" equipment. In return, the farmer does not have to make any of the operating lease payments or make a large down payment on the lease. If the trade is a **capital lease,** the IRS treats the transaction as a financing arrangement (i.e., a loan), and no gain is triggered on the trade if no cash is received. There is no deduction for the lease payments but interest may be deductible. If the trade constitutes an **operating lease,** the farmer has gain equal to the amount of "trade-in" value that is credited to the operating lease, minus the farmer's adjusted tax basis in the owned equipment. The farmer gets a lease expense deduction each year of the lease based on the trade-in value divided by the lease term. Therefore, the gain can be offset (partially or fully) with the lease expense (lease cost amortized for the year of sale).

Example 13. On June 1, 2016, Bosworth traded in a used, fully depreciated tractor worth $120,000 for a new tractor. He makes the transaction under an operating lease with a 4-year term. Bosworth has ordinary income of $120,000 in 2016 because that is the trade-in value that is credited to the operating lease. He can deduct the lease payments made in 2016 and later years as a business expense.[60]

If the trade occurred late in 2016, Bosworth might not have any lease expense that he could claim in 2016. However, he can claim $30,000 ($120,000 ÷ 4 years) as a lease expense deduction over each of the next four years (2017–2020).

SPLIT-INTEREST LAND ACQUISITIONS

A split-interest transaction involves one party acquiring a **temporary interest** in the asset (such as a term certain or life estate), with the other party acquiring a **remainder interest.** The temporary interest may either refer to a specific term of years (i.e., a term certain such as 20 years), or may be defined by reference to one or more lives (i.e., a life estate). The remainder holder then succeeds to full ownership of the asset after expiration of the term certain or life estate. Each year, a portion of the temporary interest is transferred to the remainder owner.

Split-interest land acquisitions can serve as a mechanism for removing after-tax income from a family corporation. In addition, if the farmland is purchased, the split-interest arrangement allows some of the cost (under the current low-interest-rate environment) to be covered by the corporation but without trapping the asset inside the corporation (where it would incur double taxation if the corporation is liquidated).

SPLIT-INTEREST TRANSACTIONS

In *Richard Hansen Land, Inc. v. Comm'r*,[61] the Tax Court affirmed that related parties, such as a corporation and its controlling shareholder, may enter into a split-interest acquisition of assets. The case involved a corporation that acquired a 30-year term interest in farmland, with the controlling shareholder acquiring the remainder interest. Based on interest rates in effect at the time, the corporation was responsible for about 94% of the land cost and the controlling shareholder individually paid for 6% of the land cost. Under the law in effect at the time, the court determined that the term interest holder's ownership was amortizable. The corporation was considered to have acquired a wasting asset in the form of its 30-year term interest.

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60. *A Trade of Equipment on an Operating Lease can be Costly.* Neiffer, Paul. May 27, 2016. CliftonLarsonAllen. [www.farmcpatoday.com/2016/05/27/trade-equipment-operating-lease-can-costly/] Accessed on Jun. 29, 2016.

61. *Richard Hansen Land, Inc. v. Comm'r,* TC Memo 1993-248 (Jun. 2, 1993).

The buyer of the term interest (including a life estate) may usually amortize the basis of the term interest ratably over its expected life. That might lead some taxpayers to believe that they could therefore take depreciation on otherwise nondepreciable property. For instance, this general rule would seem to allow a parent to buy a life estate in farmland from a seller (with the children buying the remainder) and amortize the amount paid over the parent's lifetime. If this is allowed, then it produces a better tax result than the more common approach of the parent buying the farmland and leaving it to the children at death. Under that approach, no depreciation or amortization would be allowed.

However, the Tax Court, in *Lomas Santa Fe, Inc. v. Comm'r*,[62] held that an amortization deduction is not available when the underlying property is nondepreciable and has been split by its owner into two interests without any new investment. Under the facts of the case, a landowner conveyed the land to his wholly owned corporation, subject to a 40-year retained term of years. He allocated his basis for the land between the retained term of years and the transferred remainder and amortized the former over the 40-year period. As previously mentioned, the court denied the amortization deduction.

In another case involving similar facts,[63] the taxpayer bought life interests in tax-exempt bonds with the remainder interests purchased by trusts that the taxpayer had created. The taxpayer claimed amortization deductions for the amounts paid for his life interests. The Tax Court denied the deductions on the basis that the substance of the transactions was that the taxpayer had purchased the bonds outright and then transferred the remainder interests to the trusts.

Related-Party Restriction

For term interests or life estates acquired **after July 28, 1989,** no amortization is allowed if the remainder portion is held, directly or indirectly, by a related party.[64]

> **Note.** This provision is the Congressional reaction to the issue raised in the *Lomas Santa Fe*[65] and *Gordon*[66] cases. Under the provision, **term interest** includes a life interest in property, an interest for a term of years, or an income interest held in trust.[67]

The term **related party** includes the taxpayer's family (spouse, ancestors, lineal descendants, brothers, and sisters) and other related persons described in IRC §§267(b) and 267(e).[68] It also encompasses a corporation in which more than half of the stock is owned, directly or indirectly, by persons related to the taxpayer. In addition, even if the transaction is not between related parties, amortization deductions could still be denied based on substance-over-form grounds.[69]

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62. *Lomas Santa Fe, Inc. v. Comm'r,* 74 TC 662 (1980).
63. *Gordon v. Comm'r,* 85 TC 309 (1985).
64. IRC §167(e)(3). IRC §167(e) does not apply to a life or other terminable interest acquired by gift because IRC §273 bars depreciation of such an interest regardless of who holds the remainder (IRC §167(e)(2)(A)).
65. *Lomas Santa Fe, Inc. v. Comm'r,* 74 TC 662 (1980).
66. *Gordon v. Comm'r,* 85 TC 309 (1985).
67. IRC §§167(e)(5)(A) and 1001(e)(2).
68. IRC §167(e)(5)(B).
69. See, e.g., *Kornfeld v. Comm'r,* 137 F.3d 1231 (10th Cir. 1998), *cert. den.* 525 U.S. 872 (1998).

If the acquisition is nonamortizable because it involves related parties, the term holder's basis in the property (i.e., the corporate tax basis, in the context of a family farm corporation transaction) is annually reduced by the amortization that would have been allowable. The remainder holder's tax basis (i.e., the shareholder's tax basis) is increased annually by this same disallowed amortization.[70] Thus, in a split-interest arrangement between a corporation and a shareholder, the corporation has full use of the land for the specified term of years. The individual shareholder (as remainderman) succeeds to full ownership after the expiration of the term of years, with the individual having the full tax basis in the real estate (less any depreciation to which the corporation was entitled during its term of ownership, such as for tiling, irrigation systems, buildings, etc.).

The IRS indicated in a letter ruling[71] that if the two purchasers are related parties, the term-certain holder could not claim any depreciation with respect to the land **or** the buildings on the land during the period of the life estate/term interest.

> **Observation.** The ruling is correct concerning the land. IRC §167(e)(1) contains a general rule denying any depreciation or amortization to a taxpayer for any term interest during the period in which the remainder interest is held, directly or indirectly, by a related party.
>
> However, the ruling is incorrect with respect to the conclusion that no depreciation would be available for the buildings on the land. IRC §167(e)(4)(B) states that if depreciation or amortization would be allowable to the term-interest holder other than because of the related party prohibition, the principles of IRC §167(d) apply to the term interest. Under §167(d), a term holder is treated as the absolute owner of the property for purposes of depreciation. Thus, this exception would allow the term holder to claim depreciation for the buildings and other depreciable property but not the land in the case of an acquisition involving a term holder and a remainderman who are related parties.

Allocation Procedure

To identify the proper percentage allocation for the term-certain holder and the remainderman, the applicable federal rate (AFR) is used. This rate is published as a revenue ruling each month by the IRS. The relevant interest rate is the mid-term 120% annual AFR (rounded to the nearest 2/10 of 1%)[72] and is contained in table 5 of the monthly AFR ruling. Once the relevant interest rate is identified, Table B of the actuarial tables found in IRS Pub. 1457, *Actuarial Valuations,* (which can be found at **uofi.tax/16a7x1** [www.irs.gov/pub/irs-pdf/p1457_99.pdf]) is used to determine the income and remainder allocations for a term certain.

Example 14. RipTiller, Inc. is a family-owned farming operation organized as a C corporation. RipTiller is owned by Dave Sr. and Dave Jr. The corporation has accumulated cash and investments as a result of applying the lower corporate tax brackets to its earnings over several years. The family wants to buy additional land, but their tax advisors have discouraged any land purchases within the corporation because double taxation of gains may result if the corporation liquidates. On the other hand, both Dave Sr. and Dave Jr. recognize that it is expensive from an individual standpoint to use extra salaries and rents from the corporation to purchase the land.

The solution that is proposed is to have the corporation acquire a 30-year term interest in the parcel of land, with Dave Jr. acquiring the remainder interest. Assuming that the AFR at the time of purchase is 4.6%, and using the actuarial table for a 30-year term, the corporation pays for 74.0553% of the land cost and Dave Jr. is obligated for 25.9447%.

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70. IRC §167(e)(3). However, there is no addition to basis if the holder of the term interest is a tax-exempt organization or a nonresident alien or foreign corporation whose income from the property is not effectively connected with U.S. businesses.

71. Ltr. Rul. 200852013 (Sep. 24, 2008).

72. IRC §7520.

However, if the AFR at the time of purchase is 1.8% (the July 2016 rate) and using the actuarial table for a 30-year term, the corporation pays for 41.4446% of the land cost and Dave Jr. is obligated for 58.5554%. A small change in the interest factor has a significant impact on the ownership allocation.

Observation. When interest rates are low (i.e., low AFR factors that determine the percentage to be paid by each party), the corporate share is smaller than it would be in periods when interest rates are higher.

RipTiller, Inc. cannot amortize its investment, but it is entitled to claim any depreciation allocable to depreciable assets involved with this land parcel. In addition, 1/30th of the corporate tax basis in the term interest is decreased each year (i.e., the nondeductible amortization of the term interest is reported as an addback on Schedule M-1 on Form 1120, *U.S. Corporation Income Tax Return)*. The corporation's basis in the term interest is amortized for book and balance sheet purposes but not allowable as a deduction for tax purposes. Dave Jr.'s deemed tax cost in the land is increased each year by an equivalent amount.

As a result, at the end of the 30-year term, Dave Jr. will have full title to the real estate and a tax cost equal to the full investment (reduced by any depreciation deductions claimed by the corporation).

Caution. Related party split-interest purchases between individuals (e.g., parent and child split-interest acquisition of farmland) should be avoided. This is because of the **potentially harsh gift tax consequences** of IRC §2702, which treats the individual acquiring the term interest, typically the senior generation, as having made a gift of the value of the term ownership to the buyer of the remainder interest. For this purpose, the related party definition is very broad and includes in-laws, nieces, nephews, uncles, and aunts. Similarly, any attempt to create an amortizable split-interest land acquisition by structuring an arrangement between unrelated parties must be carefully scrutinized in terms of analyzing the IRC §267 related-party rules and family-attribution definitions.

ADVANTAGES OF SPLIT-INTEREST LAND ACQUISITIONS

Because land is not depreciable, the most efficient form of acquisition is to use earnings subject to a low tax rate. A closely held C corporation is an efficient entity for creating after-tax dollars, as it can do so annually on up to $50,000 of income taxed at 15%. Even though C corporation after-tax dollars are used for the acquisition of a portion of the land cost, the split-interest technique avoids the long-term negative consequence of having the farmland trapped inside the C corporation. This reduces the risk of double taxation of land appreciation.

Even though corporate dollars are used to acquire a portion of the asset, an individual taxpayer obtains full tax basis in the asset at the end of the term (reduced by any tax depreciation allowable to the corporation on the depreciable portion of the property). The remainderman acquires basis in the real estate without making any additional economic outlay.

At the conclusion of the term, **after-tax corporate dollars** have been used to acquire land now owned fully by an individual. If land were to be sold at that time, the more favorable individual capital gain rates would apply.

DISADVANTAGES OF SPLIT-INTEREST LAND ACQUISITIONS

The individual who buys the **remainder interest** must do so entirely from other sources of after-tax earnings. The land produces no income to the remainderman during the period that the land is available for use by the corporation under the specified term certain. Additionally, if the land is purchased under a contract or installment payment arrangement, each party must contribute either to the down payment or the contract.

> **Note.** The party with the cash for the down payment may provide any portion or all of such down payment, with an adjustment for that party's contribution to the contract. The contract may provide for interest-only payments by one party, until the other party's contribution toward the purchase has been fully paid.

Example 15. Sow's Ear, Inc. has been retaining equity of approximately $40,000 per year ($50,000 taxable income minus state and federal taxes) for a number of years. Chuck, the corporate president, would like to purchase additional land with the funds that the corporation has accumulated. However, having the corporation purchase the land would trap that land inside the corporation and potentially expose it to double taxation upon liquidation as well as eliminating capital gain rates if the corporation had to sell the land.

A split-interest purchase is an alternative solution. The land can be purchased for $1 million, with $450,000 down and a contract at 5% for the balance, with payments of $52,988.26 annually for 15 years. Chuck plans to farm for another 20 years through the corporation. Assume the monthly IRS interest rate for a 20-year split-interest purchase requires the term-interest holder to pay 58% of the total purchase price, or $580,000.

Sow's Ear, Inc. agrees to pay $200,000 of the down payment. Its share of the remaining balance due is $380,000. Chuck, as the remainder holder, is responsible for $420,000 ($1 million − $580,000). The balance of the down payment may be made by either party. If Sow's Ear, Inc. borrows to satisfy the remaining down payment of $250,000, it assumes $130,000 of the $550,000 note payable for the balance due ($580,000 − $200,000 down payment − $250,000 remaining down payment). All of Chuck's portion of the purchase price is funded by the remaining balance due on the loan of $420,000.

Each party must pay interest that economically accrues on its share of the seller-financed debt. Otherwise, the below-market interest rate rules apply, which tie in with original issue discount (OID) requirements. The parties may determine the share of principal to be paid by each, as long as a total of $52,988.26 annually is paid to satisfy the requirements of the seller-financed note. Because Chuck, as the remainderman, has no cash flow coming from the property for the next 20 years, he must obtain funds from sources other than rents from the property to fund his payments. The deductibility of interest expense is subject to the passive activity rules of IRC §469.

> **Note.** For information about OID rules, see the 2012 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 8: Investment Income. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

SALE OF SPLIT-INTEREST PROPERTY

If a sale occurs during the split ownership of the property, the sale proceeds **must be allocated** between the corporate term holder and the individual remainderman based on the IRS interest rate and the remaining term-certain periods as of the date of the sale. After allocating the sale proceeds to each party, gain or loss is recognized by each party (the corporate term holder and the individual remainderman) by comparing the sale proceeds to the adjusted tax basis of the property. The adjusted tax basis should reflect the nondeductible amortization adjustment occurring annually and the shift of this basis to the remainderman in accordance with IRC §167(e)(3).

Example 16. RipTiller, Inc. and Dave Jr. (from **Example 14)** purchased another farm in 2009 (seven years ago) for $200,000, with the corporation acquiring a 32-year term certain. Using interest rates in effect at that time, Dave Jr. was required to pay $25,000 and the corporation paid $175,000 toward the farm purchase price. Of the corporate basis, $20,000 was allocated to depreciable tiling and $155,000 to the land cost.

By 2016, the corporation depreciated approximately $9,000 of the $20,000 allocated to tiling, leaving an adjusted basis of approximately $11,000. The land basis of $155,000 was reduced annually using straight-line nondeductible amortization over the 32-year term certain. Approximately $4,800 per year of amortization was taken on the land basis over the corporation's 7-year holding period, resulting in a total reduction to the corporate basis of approximately $33,600. The amortization is treated as land basis reductions to the corporation, and as land basis increases to Dave Jr. Accordingly, at the time of the sale of the farm, the adjusted tax basis to each party is as follows.

Dave Jr.'s Basis

At purchase	$25,000
Statutory increase for amortization	33,600
Total adjusted tax basis	$58,600

Corporate Basis

	Land	Tiling	Total
Basis at purchase	$155,000	$20,000	$175,000
Deductible depreciation		(9,000)	(9,000)
Statutory amortization	(33,600)		(33,600)
Adjusted basis	$121,400	$11,000	$132,400

If the farm is sold for $250,000, the term certain percentage and remainder percentage must be calculated for a term certain with 25 years remaining. Assume that the current IRS mid-term 120% annual AFR is 1.80%. According to the IRS actuarial table B for 1.80%, the 25-year income right is 35.9815% and the remainder right is 64.0185%. Therefore, $89,954 of the sale proceeds are allocable to the corporation ($250,000 × 35.9815%) and the remaining $160,046 is allocable to Dave Jr. RipTiller's adjusted tax basis in the land and tiling of $132,400 is deducted from its proceeds of $89,954, resulting in a loss of $42,446. Dave Jr.'s adjusted tax basis in the land and tiling of $58,600 is deducted from his proceeds of $160,046, resulting in a capital gain of $101,446.

Observation. Interest rates at the time of purchase compared to interest rates at the time of sale can have a major influence on the allocations of gain or loss under the split-interest rules. In this example, interest rates dropped from the time of purchase to the time of sale. Dave Jr. had a much higher percentage of the sale price allocable to his remainder interest, and incurred a significant capital gain. RipTiller incurred a significant capital loss that may not be currently deductible.

SPLIT-INTEREST PURCHASES WITH UNRELATED PARTIES

The IRS addressed the tax effects of split-interest purchases in which the term holder and the remainder holder are unrelated parties. In two letter rulings[73] that appear to address the same set of facts, two unrelated buyers acquired several parcels of commercial real estate that included both depreciable buildings and land. The first buyer acquired a 50-year term interest in the property, and the second buyer acquired a remainder interest in that same property. The IRS determined that the buyer of the term interest was entitled to depreciate the commercial real estate (which the buyer of the term interest intended to use in its active conduct of renting commercial and residential property) ratably over the 50-year period of the term certain. The portion of the taxpayer's basis allocable to the buildings was held to be depreciable under the normal IRC §168 MACRS recovery periods. In addition, the IRS determined that the holding period for the buyer of the remainder interest began at the time of the purchase.

Observation. A term-certain remainder purchase arrangement of farmland in which the two parties are unrelated is a term-certain depreciable interest in the land. Examples of unrelated parties under IRC §267 for these rules includes cousins and in-laws, such as a father-in-law, brother-in-law, or sister-in-law.

ENTITIES FOR FARM SUCCESSION PLANNING

At its core, succession planning is a process for identifying and developing people with the potential to fill key leadership positions in a business. Succession planning increases the availability of experienced and capable employees that are prepared to assume these key roles as they become available. Succession planning is more than simply finding a replacement for current generation leaders. It involves a series of steps integrated into estate and business planning to produce an effective leadership transition to individuals interested in and capable of taking over the business.

Many business and personal issues must be considered. Ultimately, the succession plan could take one of several forms including a sale to a third party, a sale to a family member, or a reorganization of the business to facilitate transfer to family members.

Observation. Succession planning combines certain elements of estate planning and business planning. In other words, aspects of a succession plan are also present in the estate and business plan.

The manner in which a farming business is organized and structured can minimize taxes and simultaneously maximize farm program payments in accordance with the limitation rules. This can be a particularly important consideration when economic conditions are challenging. Balancing liability concerns with tax minimization and, at the same time, finding the optimal structure for purposes of farm program payment limitations is a significant factor in farm and ranch estate, business, and succession planning. Additionally, planning often involves minimizing the impact of the net investment income tax[74] (NIIT) and SE tax.

Note. For more information about the NIIT, see the 2014 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Affordable Care Act Update. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

This section compares two popular entity choices that are utilized for business succession purposes: the family limited partnership (FLP) and the limited liability company (LLC).

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73. Ltr. Rul. 200852013 (Sep. 24, 2008); Ltr. Rul. 200901008 (Oct. 1, 2008).

74. IRC §1411. The tax is 3.8% of net investment income.

FAMILY LIMITED PARTNERSHIP[75]

> **Note.** In early August 2016, the Treasury issued a proposed regulation under IRC §2704 that could impact the ability to generate valuation discounts for the transfer of interests in family-owned entities such as FLPs and LLCs. The proposed regulation eliminates the ability to value an interest in an entity (in the aggregate) at an amount less than the value of the property if it had not been contributed to the entity (minority discounts and marketability discounts). The IRS view is that the lower value of the property as contained in the entity is an inappropriate way to avoid transfer taxes. Importantly, the proposed regulation was issued by itself and not also as a temporary regulation and does not have any provision stating that a taxpayer can rely on it until it is issued as a final regulation.
>
> The amendments of the proposed regulation apply to the lapse of any right created on or after October 8, 1990, that occurs on or after the date the proposed regulation is published in the Federal Register as a final regulation.

An FLP is a limited liability business entity created and governed by state law. It is generally composed of two or more family members and is typically utilized to reduce income and transfer taxes, act as a vehicle to distribute assets to family heirs while keeping control of the business, ensure continued family ownership of the business, and provide liability protection for all of the limited partners.[76]

There are several key distinguishing characteristics of an FLP.

1. The FLP interests are held by family members (or entities controlled by family members). These typically include spouses, ancestors, lineal descendants, and trusts established on behalf of such family members.
2. A member holding a general partner interest is entitled to reasonable compensation for work done on behalf of the FLP. These payments are not deemed to be distributions and are beyond the reach of judgment creditors. Limited partners take no part in FLP decision making and cannot demand distributions or force a liquidation; they can only sell or assign their interests with the consent of the general partners.
3. FLP income, gain, loss, deductions, or credits can be **allocated to a partner disproportionately** in whatever manner the FLP desires if such allocation has a **substantial economic effect.**[77] It is not tied to the capital contributions of any particular partner.
4. The FLP owns income-producing family business property or investment property (not personal assets) and must be created for a business purpose.
5. All formalities of existence, such as the following, must be observed.
   - Executing a written partnership agreement that establishes the rights and duties of the partners
   - Filing all the necessary certificates and documents with the state
   - Obtaining all necessary licenses and permits
   - Obtaining a federal identification number
   - Opening new accounts in the FLP's name
   - Transferring title to the assets contributed to the FLP

75. *Business Succession Planning: Family Limited Partnership.* Select Portfolio Management, Inc. [www.selectportfolio.com/upload/articles/SPM%20-%20White%20Paper%20-%20Business%20Succession%20Planning%20-%20Family%20Limited%20Partnership.pdf] Accessed on Jun. 16, 2016.

76. Ibid.

77. IRC §704(b)(2).

- Amending any existing contracts to reflect the FLP as the real party in interest
- Filing annual federal, state, and local tax returns
- Not commingling partnership assets with any individual partner's personal assets
- Keeping appropriate business records
- Including income from the FLP interest on personal tax returns filed annually

Note. The transfer of an FLP interest must be "bona fide." That means it serves a substantial business or other nontax purpose.[78] However, even if the FLP is validly formed and properly recognized for federal estate tax purposes, the FLP can be disregarded if there is deemed to be an "implied understanding" at the time of formation that the transferor(s) would retain enjoyment and economic benefit of the transferred assets for life.[79]

Note. Under IRC §2036, the value of the gross estate includes the value of all property to the extent of any interest of which the decedent has at any time made a transfer (except by a bona fide sale for full consideration), under which the decedent retained:

- The possession or enjoyment of, or the right to the income from, the property; or
- The right to the income from the property or the right to designate the persons who will possess or enjoy such income.

Initial Considerations and Procedure

An FLP is formed by family members who transfer property in return for an ownership interest in the capital and profits of the FLP. At least one family member must be designated as the general partner. Alternatively, a corporation could be established as the general partner. The general partner manages and controls the FLP business and decides if and when FLP income is distributed and in what amount. In return for that high degree of control, the general partner is held personally liable for any creditor judgment that is not satisfied from FLP assets.

Consequently, income is retained in the FLP at the sole discretion of the general partner and the general partner has complete control over the daily operations of the business. Conversely, because a limited partner has no say in how the business is operated, the personal liability of the limited partner is limited to the value of that partner's capital account (generally, the amount of capital the partner contributed to the FLP).

There are several common approaches in FLP formation and utilization.

- Often, an FLP is formed by the senior generation, with those persons becoming the general partners. The remaining interests are established as limited partner interests. Those interests are then typically gifted to the younger generation and are potentially subject to gift tax.
- As an alternative, an FLP could be created by spouses transferring assets to the entity in return for FLP interests. Under this approach, one spouse receives a 99% limited partnership interest and the other spouse a 1% general partnership interest. The spouse holding the limited partnership interest could then make annual gifts of the limited partnership interests to the children (or their trusts). These annual gifts are reported on gift tax returns unless they are limited to the annual gift tax exclusion amount ($14,000 for 2016). The spouse holding the general partnership interest retains control of the "family assets," while the spouse holding the limited partnership interest is the transferor of the interests. This strategy slows the transfer of assets because the annual gifting exclusion is only utilized by one spouse.

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78. See, e.g., *In re Turner,* 335 BR 140 (Bankr. N.D. Cal. 2005).

79. See, e.g., *Estate of Thompson,* 382 F.3d 367 (3rd Cir. 2004).

> **Note.** IRC §2036 does not have a provision similar to IRC §672(e), in which the grantor is treated as holding the powers of the grantor's spouse. Thus, if one spouse retains control of the partnership and the other spouse is the transferor of the limited partnership interests, then §2036 should not apply.

Even though the general partner controls the FLP, the general (in addition to limited) partner interest can benefit from substantial valuation discounts due to its minority interest.

> **Note.** The general partner should own at least 1% of the FLP. Anything less risks IRS scrutiny.

Example 17. Bob is 55 and owns a farming operation. His wife, Stella, died in 2014. All of the assets were titled in Bob's name. Thus, Stella's estate was very small and her unused estate exclusion of $5 million was "ported" over to Bob.

The farming business expanded over the years and now is composed of 1,000 acres of farmland valued at $10 million and other assets (livestock, buildings and equipment, etc.) valued at $3 million.

Bob's three sons (ages 27, 24, and 18) work with him in the farming business. Bob's objective is for the farming operation to continue to be operated by the family in subsequent generations. He would like to transfer ownership of some of the farming business to his sons before the assets appreciate further in value. However, Bob is concerned that his sons may not be adequately experienced and ready to manage the farming operation. Bob also wants to protect the sons against personal liability that could arise in connection with the business.

After consulting with his attorney, Bob decides to have the attorney draw up an FLP agreement. The terms of the FLP agreement designate Bob as the general partner with a 1% ownership interest. The sons are designated as the limited partners, each having a 33% limited partner interest. Bob transfers the land, farm equipment, and some livestock to the FLP, and each son contributes cash and additional livestock and equipment. All other formalities for formation of the FLP are completed.

Bob then gifts 99% of the FLP to his sons (33% to each son), reports the gifts, and pays the gift tax (using the annual exclusion and the unified credit to substantially offset the gift tax). Bob continues to run the farming operation until he is 65, at which point he is comfortable that the sons can manage the farming operation on their own. Up until age 65, Bob filed the required annual reports with the state and followed all necessary FLP formalities. Bob distributed FLP income annually — 1% to himself and 33% to each son. By shifting most of the income to the sons, who are in a lower tax bracket than Bob, the family (on a collective basis) saves income tax.

When Bob reaches age 65, the partners vote to name the oldest son (now age 37) as the general partner, and Bob's interest is changed to a limited partner interest. Bob then retires.

The value of the business continues to increase over the years, but some of that appreciation in value escapes taxation in Bob's estate because only 1% of the FLP value at the time of his death is included in his estate for federal estate tax purposes.

Advantages of an FLP

An FLP is generally taxed like a partnership. There is no federal tax imposed on the FLP and taxes are not imposed on assets passing from the FLP to the partners (unlike an S corporation). Thus, the FLP is not recognized as a taxpayer, and the income of the FLP passes through to the partners, usually based on their ownership interest. The partners report the FLP income on their individual income tax returns and must pay any tax due. Income is allocated to each partner to the extent of the partner's share attributable to their capital (or pro-rata share).

Example 18. Tom established an FLP with his children, Tammy and Faye. Tom contributed $40,000 to the FLP. He contributed half of that amount ($20,000) for himself and 25% each ($10,000) for Tammy and Faye.

The FLP has $100,000 of net income in 2016. Tom is taxed on $50,000 of the income (50%), and Tammy and Faye are each taxed on $25,000 (25% each).

Note. The general partner is entitled to a management fee for services rendered. This is reflected as a guaranteed payment, which is taxable to the general partner as ordinary income and subject to SE tax. SE tax is discussed later in this chapter.

Observation. The FLP can be an attractive vehicle if a transfer of interests to family members in a lower tax bracket is desired. Transfers of FLP interests can also be made to minor children if they are competent to manage their own property and participate in FLP activities. However, such transfers are typically made in trust on behalf of the minor. Also, unearned income of children under age 18 (under 24 for full-time college students) may be subject to the "kiddie tax" and thus be taxable at the parents' income tax rate.

Avoidance of Transfer Taxes. Another advantage of an FLP is that it can help avoid transfer taxes—estate tax, gift tax, and generation-skipping transfer tax (GSTT). Transfer tax avoidance is accomplished in the following three ways.

1. **Removal of future asset appreciation** — The distribution of assets among family members via the FLP freezes the current value and keeps any future asset appreciation out of the estate at the time of death. Although gift tax or GSTT may have to be paid when the assets are transferred to the FLP, that amount is less than the tax on appreciated values in the future.

2. **Utilization of the present interest annual exclusion for gift tax purposes —** Although gifts of FLP interests are subject to gift tax, the tax can be minimized or eliminated by taking advantage of the present interest annual exclusion, which is $14,000 per donee in 2016. (A **present interest gift** is defined as a gift that the recipient can immediately use.)

Note. To take advantage of the present interest annual exclusion for gifts of FLP interests, the FLP agreement must be properly drafted and cannot place too many restrictions on the limited-partner donee to presently derive some economic benefit from the gift. The limited partner needs the ability to reach the gift when it is given. Too many restrictions could cause the IRS to determine that the gift is of a future interest, which would cause the annual exclusion to be disallowed.[80] This is a particular concern if the gift of the FLP interest is in a trust. To qualify for the present interest annual exclusion, the trust must be structured to include *Crummey* withdrawal rights.[81] Such rights give the trust beneficiaries (the limited partners) the unrestricted right to demand, for a reasonable period, any amounts placed in the trust. A *Crummey* provision causes the transfer of the FLP interests to the trust to qualify for the present interest annual exclusion. It does not matter that the demand right is not exercised.

80. See, e.g., *Hackl v. Comm'r,* 118 TC 279 (2002), *aff'd* 335 F.3d 664 (7th Cir. 2003). See *Estate of Purdue v. Comm'r,* TC Memo 2015-249 (Dec. 28, 2015), in which gifts to a family LLC qualified for the present interest annual exclusion.

81. The concept originated with the case of *Crummey v. Comm'r,* 397 F.2d 82 (9th Cir. 1968). *Crummey* withdrawal rights allow the trust beneficiaries to withdraw gifts made to the trust for a limited period. The withdrawal right allows gifts to the trust to qualify for the federal gift tax annual exclusion.

3. **Use of valuation discounts for both gift and estate tax purposes —** The transferor of the FLP interests can discount the value of the FLP interests that are gifted because of the restricted rights of the limited partner (in accordance with the FLP agreement). These restrictions include the inability to transfer the interest, the inability to withdraw from the FLP, and the inability to participate in management of the FLP. These restrictions result in a business value that is significantly less than the value of the underlying assets, in some situations up to 35% less than FMV.[82] The discount is available for gift, estate, and GSTT purposes and is composed of a lack of control discount due to holding a minority interest (inability to force distributions or liquidation or dissolution of the FLP) and a lack of marketability discount (inability to sell or transfer the FLP interest).

Note. The IRS may seek to offset valuation discounts by asserting a **control premium** on FLP interests. The control premium applies if a partner has control of the entity or the ability to swing control one way or the other. The IRS theory is that centralized control increases the value of the business. Also, the IRS has success in challenging valuation discounts upon the finding of certain factors, particularly formation of the FLP shortly before a partner's death solely to avoid estate tax or depress asset values. However, the existence and size of a control premium is heavily fact dependent, with the key question being how much the value of the entity can be enhanced.

Transfer of Assets yet Maintenance of Control. Another advantage of an FLP is that it allows a senior member of the family to distribute assets currently and maintain control over those assets as the general partner with as little as a 1% interest in the FLP. This can allow the general partner to control cash flow, income distribution, asset investment, and all other management decisions. The person holding the small general partner interest may also have a larger limited partner interest at the time of initial transfer with the limited partner interests transferred over time to the next generation.

Caution. IRC §2036(a)(1) provides that the gross estate includes the value of property previously transferred by the decedent if the decedent retained the possession or enjoyment of, or the right to the income from, the transferred property prior to the decedent's death.[83] IRC §2036(a)(2) provides that the gross estate includes property previously transferred by the decedent if the decedent retained the right, either alone or in conjunction with any person, to designate the persons who are to possess or enjoy the transferred property or its income. Thus, under §2036(a)(2), the IRS may claim that because a general partner controls partnership distributions, a transferred partnership interest should be taxed as part of the general partner's estate.

In the typical FLP scenario, the parents establish the FLP with themselves as the general partners and then gift the limited partnership interests to their children. In this situation, if the general partners have the discretionary right to determine the amount and timing of the distributions of cash or other assets (rather than the distributions being mandatory under the terms of the partnership agreement), the IRS could argue that the general partners (who have transferred interests to the limited partners) have retained the right to designate the persons who will enjoy the income from the transferred property.

82. See e.g., *Estate of Watts,* TC Memo 1985-595 (Dec. 9, 1985). (Discount of partnership interest for nonmarketability for federal estate tax purposes); *Peracchio v. Comm'r,* TC Memo 2003-280 (Sep. 25, 2003). (Gifts of FLP interests discounted 6% for minority interest and 25% for lack of marketability). *Estate of Kelley v. Comm'r,* TC Memo 2005-235 (Oct. 11, 2005). (FLP interest valued under net asset value method with 35% discount).

83. An exception exists for transfers made pursuant to a bona fide sale for adequate and full consideration.

Consolidation of Family Assets. An FLP keeps the family business in the family, with the limited partner interests restricted by the terms of the partnership agreement. Such restrictions typically include the inability of the limited partner to transfer an FLP interest unless the partnership or other partners are first given the opportunity to purchase (or refuse) the interest. If the restrictions are utilized, this virtually guarantees that nonfamily members will not own any of the business interests. These agreements (buy-sell agreements and rights of first refusal) must:

- Constitute a bona fide arrangement,
- Not be a device to transfer property to family members for less than full and adequate consideration, and
- Have arm's-length terms.

An agreement structured in this manner produces discounts from FMV for transferred interests that are subject to the agreement.

Provision for Nonbusiness Heirs. The FLP can provide for children who are not in the family business and allow for an even distribution of the estate among all family members. The limited partner interest of an heir who is not part of the farming business can allow that heir to derive an economic benefit from the periodic income distributions without being involved in the day-to-day operation of the business.

Asset Protection. The FLP can serve as an asset protection device. This is particularly the case for the limited partners. A limited partner has no ownership over the assets contributed to and now owned by the FLP, thus the creditor's ability to attach those assets is severely limited. In general, a court order (called a "charging order") would be required to reach a limited partner's interest. Even if the order is granted, the creditor only receives the right to FLP income to pay the partner's debt until the debt is paid. The creditor still cannot reach the FLP assets.[84] However, a general partner does not receive the same creditor protection unless the general partner interest is structured as a corporation.

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> **Note.** Caution should be taken before establishing a corporation as the general partner. Establishing a corporation as a general partner cannot be merely a sham to avoid liability. If it is, the IRS and/or the courts could ignore it and pierce the corporate veil. To avoid this from happening, **the corporation must be kept separate from the FLP.** Funds and/or assets must not be commingled between the FLP and the corporation. In addition, all formalities must be observed to maintain the corporate status such as keeping records and minutes, holding directors' and shareholders' meetings, and filing annual reports.

Other Advantages. Other advantages to a FLP include the following.

- **Flexibility —** The FLP can provide flexibility because the FLP agreement can be amended by vote in accordance with the FLP agreement.
- **Consolidation of assets —** The assets of both the general and limited partners are consolidated in the FLP. This can provide for simplification in the management of the family business assets, which could lead to cost savings. In addition, the management of the assets and related investments can be managed by a professional, if desired.

84. The limited partnership agreement and state law are crucial with respect to charging orders. Also, a charging order could put a creditor in a difficult position because tax is owed on a partner's share of entity profits even if they are not distributed. Thus, a creditor could be liable for taxes, with no income flowing from the partnership to pay the obligation.

- **Minimization or elimination of probate —** Assets may be transferred to the FLP and the ownership interests may be transferred to others, with only the FLP interest owned at the partner's death being subject to probate. Upon the partner's death, the FLP continues to operate under the terms of the FLP agreement, ensuring continuity of the business without any disruption caused by the death of an owner. An FLP also typically avoids the need for an ancillary probate (probate in the nondomiciliary state) at the FLP interest owner's death. Most states treat FLP interests as personal property even if the FLP owns real estate. To the extent probate is avoided, privacy is maintained.
- **Partnership accounting rules —** The rules surrounding partnership accounting, while complicated, are relatively flexible.
- **Ease of gifting —** The FLP structure does provide a mechanism that can make it easier for periodic gifting to facilitate estate and tax planning goals.

Disadvantages of an FLP

Although there are distinct advantages to using an FLP in the estate and business succession planning context, those advantages should be weighed against potential drawbacks. The disadvantages of using an FLP can include the following.

1. An FLP is a complex form of business organization that requires competent legal and tax consultation to establish and maintain. Thus, the cost of formation could be relatively higher than other forms of doing business.
2. The general partners have unlimited liability.

> **Note.** Slightly over half of the states have enacted legislation allowing the formation of a limited liability limited partnership (LLLP), which is typically accomplished by converting an existing limited partnership to an LLLP. In an LLLP, any general partner has limited liability for the debts and obligations of the limited partnership that arise while the LLLP election is in place. Some states (such as California) that do not have a statute authorizing the formation of an LLLP recognize LLLPs formed under the laws of another state. In addition, while Illinois does not authorize LLLPs by statute, it does allow the formation of an LLLP under the Revised Uniform Limited Partnership Act by checking a box on Form LP 201, *Certificate of Limited Partnership.*

3. FLP members are not employees and are ineligible for many of the tax-free fringe benefits that are available to employees.
4. The gifts of FLP interests must be carefully planned to avoid filing of gift tax returns or triggering unexpected estate, gift, or GSTT liability.
5. Establishing an FLP can be costly in terms of the legal work necessary to draft the FLP agreement, change titles to assets, and pay appraisers,[85] tax accountants, and state and local filing fees.
6. There could be additional complications in community property states. In community property states, guaranteed payments (compensation income) from an FLP are treated as community property. However, FLP income distributed at the discretion of the general partner(s) is classified as separate property.

85. The key to FLP valuation discounts is the proper valuation of FLP interests that are transferred by gift or at death, without regard to the ownership of other interests in the entity by family members. The appraiser must disregard the fact that the recipient of the minority interest may, in fact, have control of the entity, when the interest that is currently transferred is combined with the interests owned by other family members. The only issue for the appraiser is what a willing buyer would pay for the interest that is transferred if that were the only interest the buyer owned in the entity.

THE LIMITED LIABILITY COMPANY

An LLC is a hybrid business organization that mixes elements of corporations, partnerships, and sole proprietorships. Because an LLC is a separate legal entity, each owner (also called a member) of an LLC has limited liability like a stockholder of a corporation. LLCs allow any entity, including individuals, partnerships, trusts, estates, corporations, or other LLCs to be owners. They also do not restrict the number of members, and can provide the tax advantages of a partnership, such as the pass-through of taxable income and losses (unless the LLC elects to be treated as a C corporation).

LLCs are not subject to many of the formalities that are typically imposed upon corporations, such as producing annual reports, holding director meetings, and meeting shareholder requirements. In addition, profit and loss can be allocated differently than ownership interests. Unlike corporations, which must distribute profits in proportion to each of the shareholder's ownership of shares, an LLC taxed as a partnership may distribute profits in any manner they want without regard to each member's capital contribution.

> **Note.** LLCs are recognized legal entities in all 50 states and the District of Columbia, and every state now permits single-owner LLCs (though some states tax LLCs like a corporation). Finally, with IRS "check-the-box" regulations, a business that is currently a sole proprietorship can change to an LLC with no federal tax consequences.

The key to a successful LLC is the operating agreement. The operating agreement governs the ownership rights of property contributed to the LLC to facilitate succession planning goals and objectives. Under the LLC operating agreement, members can have ownership rights without any concern about the partition rights of other members, and the agreement can severely restrict remedies available to creditors of any particular member. Likewise, the operating agreement can prevent ownership of LLC interests from passing to former spouses, unrelated parties, and creditors.

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Management Structure and Self-Employment Tax

Management of an LLC may be vested in its members or by an appointed manager.

Member-Managed LLC. By default, state LLC statutes treat LLCs as member-managed. The owners of the LLC are responsible for managing the company in a member-managed LLC. Thus, all of the members are treated as general partners and their distributive share of business income is subject to SE tax liability.

Manager-Managed LLC. A manager-managed LLC is operated by managers who are appointed to run the company. Manager-managed LLCs are designated as such in the LLC formation documents or the LLC operating agreement, and operate in a similar fashion to a corporation that has a board of directors to control the company's affairs.

A manager-managed LLC has at least one member who takes a passive role in terms of operating the company. This feature can provide SE tax savings while maintaining limited liability. In addition, the managers of the LLC can be members, but they are not required to be.[86] However, only the designated manager (or managers) in a manager-managed LLC has SE tax liability on their distributive share of LLC business income. Thus, a manager-managed LLC may provide separate classes of membership for managers (who have the authority to bind the LLC under a contract) and nonmanagers (who have no such authority). From an SE tax perspective, the use of a manager-managed LLC with two classes of membership provides SE tax savings to the nonmanaging members.

> **Note.** Both the manager interest and the nonmanager interest provide liability protection to the members.

86. In a manager-managed LLC, unless state law provides otherwise, a manager can be an entity such as an LLC or a corporation.

SE Tax. In general, income that is subject to SE tax is not subject to the NIIT, which is effective for tax years beginning after 2012.[87] Business income allocated to the general members of an LLC taxed as a partnership is generally subject to SE tax even if it flows to a member who does not participate in the operations of the LLC.[88] **There is no guidance on the SE tax treatment of income flowing to LLC and limited liability partnership (LLP) owners who do not participate in the operations of the business.** However, to the extent a limited liability owner (either an LLC member or an LLP partner) receives a guaranteed payment for services, the law is clear that this payment is subject to SE tax. Thus, guaranteed payments for services or capital always appear to be subject to SE tax, even if paid to an individual holding a limited liability interest. Presumably, LLC members (in an LLC that is taxed as a partnership) have SE tax liability on their distributive share of business income unless the member is treated as a limited partner.[89]

In the 1990s, the Treasury Department issued proposed regulations in an attempt to clarify the SE tax status of LLC members.[90] The proposed regulations were withdrawn in early 1997 and new proposed regulations were issued. Under the 1997 proposed regulations, a partnership (or LLC taxed as a partnership) member is subject to SE tax under any one of three circumstances.[91]

1. The individual has personal liability for the debts of, or claims against, the partnership by reason of being a partner or member.
2. The individual has authority under the statutes of the state in which the partnership is formed to contract on behalf of the partnership (i.e., the individual has management authority).
3. The individual participated in the entity's trade or business for more than 500 hours during the entity's tax year.[92]

If an LLC member in a manager-managed LLC is treated under the proposed regulations as being subject to SE tax on their distributive share, there remain two possible exceptions by which the member can still be treated as a limited partner and avoid SE tax. Both exceptions are tied to the fact that a manager-managed LLC may provide separate classes of membership for managers (who have the authority to bind the LLC under a contract) and nonmanagers (who have no such authority).

1. The first exception applies if the members who did not meet the tests of the proposed regulations (i.e., are mere investors) own a "substantial, continuing interest" in a specific class of interests in the LLC, and these members' rights and obligations in that class of interests are the same as the rights and obligations that other members (who do meet the requirements of the proposed regulations) hold in that class.[93] A "substantial interest" is determined based on all the relevant facts and circumstances. However, ownership of a class of interest exceeding 20% is always considered substantial.[94]
2. The second exception applies to those members who participate in the LLC business for more than 500 hours during the entity's tax year. Such a person can still be treated as a limited partner (and escape SE tax on their distributive share) if there are other members that meet the requirements of the first exception.

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87. IRC §1411.
88. Treas. Reg. §1.1402(a)-2(g).
89. IRC §1402(a)(13); Prop. Treas. Reg. §1.1402(a)-2(g). IRC §1402(a)(13) specifies that the distributive share of a limited partner in a limited partnership is not subject to SE tax.
90. 59 Fed. Reg. 67,253 (Dec. 29, 1994).
91. Prop. Treas. Reg. §1.1402(a)-2(h)(2). The IRS is bound by any proposed regulation that a taxpayer reasonably relies on. See *Elkins v. Comm'r,* 81 TC 669 (1983). Also, a taxpayer that reasonably relies on a proposed regulation will avoid taxpayer penalties. See *U.S. v. Boyle,* 469 U.S. 241 (1985). The same is true for a tax practitioner.
92. This is not to be confused with the 500-hour test for material participation under the passive activity rules of IRC §469.
93. Prop. Treas. Reg. §1.1402(a)-2(h)(3).
94. Prop. Treas. Reg. §1.1402(a)-2(h)(6).

Accordingly, nonmanagers who participated more than 500 hours in the LLC's business are not subject to SE tax, except to the extent of any guaranteed payments they receive. Nonmanagers who participated more than 500 hours are not subject to SE tax if they own a substantial, continuing interest (generally, 20%) in a class of interest and the individual's rights and obligations of that class are identical to those held by persons who satisfy the general definition of limited partner (i.e., less than 500 hours for a nonmanager).

LLC manager-members are subject to SE tax on income from that interest. If there are nonmanagers who spend less than 500 hours with the LLC and such members own at least 20% of the LLC interests, those nonmanagers who spend more than 500 hours are not subject to SE tax on the pass-through income, but are subject to SE tax on the guaranteed payments.[95]

A manager-managed LLC may be structured such that a taxpayer holds both manager and nonmanager interests. In this type of structure, individuals with nonmanager interests who spend less than 500 hours with the LLC must own at least 20% of the LLC interests. As a result, the individual who holds both manager and nonmanager interests is exempt from SE tax on the nonmanager interest,[96] but remains subject to SE tax on the pass-through income and guaranteed payments of the manager interest.

Following is a summary of the **most important SE tax implications.**

- Although the managers and nonmanagers own interests commensurate with their investment (i.e., nonmanager interests), the managers also receive manager interests as a reward for their services.
- Managers recognize SE income on the pass-through income associated with the manager interests.
- LLC nonmanagers working fewer than 500 hours annually are subject to SE tax only on guaranteed payments.
- Nonmanagers who work more than 500 hours annually are subject to SE tax only on guaranteed payments if the nonmanagers who work fewer than 500 hours annually make up at least 20% of the membership.

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

> **Note.** With respect to the NIIT, there is a special rule that comes into play when spouses are involved. Although a nonmanager's interest in a manager-managed LLC is normally considered passive and is subject to the NIIT,[97] a spouse may take into account the material participation of a spouse who is the manager.[98] Thus, if the manager-spouse materially participates, then **all** nonmanager interest(s) owned by both spouses avoid the NIIT. That gives even more power to the manager-managed LLC with bifurcated interests.

95. Prop. Treas. Reg. §1.1402(a)-2(h)(4).

96. Prop. Treas. Reg. §1.1402(a)-2(h)(3).

97. IRC §1411(c)(2)(A).

98. IRC §469(h)(5).

ENTITY STRUCTURING AND FARM PROGRAM BENEFITS

A **payment limitation** is a maximum dollar amount that can be received annually under various programs by a person or legal entity.[99] Under the 2014 Farm Bill, the per-person payment limitation is generally $125,000. Conservation programs have multiple limits. Peanut growers are allowed an additional $125,000 payment limitation.

If one spouse (or estate of a deceased spouse) is considered to be actively engaged, the other spouse is considered actively engaged and entitled to an additional $125,000 payment limit.[100] These payment limits are applied at both the entity level and the individual level (up to four levels of ownership). General partnerships and joint ventures have payment limits determined by the number of persons and legal entities that comprise the ownership of the joint operation.[101] However, an entity that limits the liability of its shareholders/members is limited to one payment limitation. That means that the single payment limit is then split equally between the shareholders/members. Payment limits for operations with nonfamily owners have further restrictions.

To be eligible for a full payment limit, the taxpayer's AGI must not exceed $900,000. The AGI limitation is an average of the three prior years, with a 1-year delay. For example, farm program payments received in 2015 are based on the average AGI for 2011, 2012, and 2013**. The AGI limitation applies to both the entity and the owners of the entity.**

Example 19. FarmCo receives $100,000 of farm program payments in 2015. FarmCo's average AGI is $850,000. Thus, FarmCo is entitled to a full payment limitation. However, if one of FarmCo's owners has an average AGI that exceeds the $900,000 threshold, a portion of FarmCo's payment limit is disallowed in proportion to that shareholder's percentage ownership. If the shareholder with income exceeding the $900,000 threshold owns 25% of FarmCo, FarmCo's farm program payment benefit is reduced by $25,000 ($100,000 × 25%).

The type of entity structure utilized to maximize payment limits depends on the size/income of the operation.

- For smaller producers, entity choice for Farm Service Agency (FSA) purposes may not be significant. Given that the limitation is $125,000 for most crops and that payments are made either based on price or revenue (according to various formulas), current economic conditions in agriculture indicate that some Midwestern farms would reach the $125,000 payment limit when operating approximately 1500–2000 acres.[102] Thus, for smaller producers, the payment limit is not likely to apply and the manner in which the farming business is structured is not a factor.

- For larger operations, the general partnership or joint venture form is likely to be ideal for FSA purposes. If creditor protection or limited liability is desired, the partnership could be made up of single-member LLCs. For further tax benefits, the general partnership's partners could consist of manager-managed LLCs with bifurcated interests.

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99. *2014 Farm Bill Fact Sheet.* Apr. 2014. USDA. [www.fsa.usda.gov/Assets/USDA-FSA-Public/usdafiles/FactSheets/2014/payment_limitations_0314.pdf] Accessed on Jun. 17, 2016.

100. Food Conservation & Energy Act, 2008 PL 110-234, section 1603(c)(6).

101. *2014 Farm Bill Fact Sheet.* Dec. 2015. USDA FSA. [www.fsa.usda.gov/Assets/USDA-FSA-Public/usdafiles/FactSheets/2015/payment_eligibility_payment_limitations.pdf] Accessed on Jul. 8, 2016.

102. *Estimated 2016 ARC-CO Payments.* Schnitkey, Gary; Paulson, Nick; and Coppess, Jonathon. Jun. 1, 2016. Farmdoc Daily. [http://farmdocdaily.illinois.edu/2016/06/estimated-2016-arc-co-payments.html] Accessed on Jul. 8, 2016.

SUMMARY OF FLP AND LLC ENTITY ADVANTAGES

Following are some additional points on the advantages of FLPs and LLCs.

- Both the FLP and the LLC allow **interests** to be transferred rather than assets. The ease of transferability of entity interests can be an important aspect of succession planning. The transfer of interests in the entity is often restricted by contractual agreement, such as a buy-sell agreement or operating agreement.
- Multiple-member LLCs that are taxed as partnerships avoid the potential double taxation that can apply upon corporate liquidation and the sale of assets but still provide liability protection.[103]
- A major advantage (as compared to corporations) of FLPs and LLCs taxed as partnerships is that the assets, with some planning, can be distributed tax-free. If the assets are sold, there is a single tax at the partner level and none at the partnership level.

CAPITALIZATION/REPAIR REGULATIONS — DE MINIMIS EXPENSING[104]

Effective for costs incurred in tax years beginning on or after January 1, 2016, the de minimis safe harbor expensing limit is $2,500 per item for taxpayers without an applicable financial statement. Supporting documentation must show that the per-unit price is $2,500 or less. However, using the new de minimis safe harbor to deduct the purchase of livestock affects the taxation of gains on the later sale of the livestock. The gains result in ordinary income and could result in SE tax.

7

APPLICATION OF THE REGULATIONS

The regulations bar the use of the de minimis safe harbor election for property that is held as inventory for resale even if the unit price per item is $2,500 or less.[105] However, purchased livestock held for **productive use** qualify for the de minimis safe harbor election. Livestock eligible to be deducted under the de minimis safe harbor include the following.

- Feeder gilts or sows
- Purchased bred heifers or cows
- Purchased springer heifers
- Purchased dairy cows
- Purchased breeding animals

The regulations hold that upon the sale or other disposition of property to which a taxpayer applied the de minimis safe harbor, the property is not treated as a capital asset under IRC §1221 or as property used in the trade or business under IRC §1231.[106] As a result, the entire gain upon disposition must be reported as ordinary income, with no IRC §1231 gain that qualifies for capital gain rates.

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103. For an LLC taxed as a partnership, each LLC member is treated as a partner for tax purposes. Schedule K-1 for each member is attached to the LLC's Form 1065 and is issued to each member.

104. A portion of this material is based on a Farm Tax Network Release, CliftonLarsonAllen, authored by Chris Hesse and Andy Biebl in December 2015.

105. Treas. Reg. §1.263(a)-1(f)(2)(i).

106. Treas. Reg. §1.263(a)-1(f)(3)(iii).

There are two schools of thought on the applicability of SE tax to gains from the sale of property expensed under the de minimis safe harbor election. One interpretation holds that gains from dispositions are excluded from SE income based on Treas. Reg. §1.1402(a)-6(a). The other holds that the gains are included in SE income because the disposition is excluded from IRC §§1221 and 1231.

> **Note.** In unofficial communication in August 2016, a representative of the IRS indicated that they believe that the gains are not included in SE income. However, the correspondent was careful to point out that this approach is based on the assumption that the livestock were neither inventory nor held for sale. They also stressed that these assumptions are highly fact dependent and should be considered on a case-by case basis. The communication also indicated that the IRS is considering adding clarifying language to IRS Pub. 225, *Farmers' Tax Guide,* and/or the Schedule F instructions.

Excluding Gains from SE Income

Reasoning. Treas. Reg. §1.1402(a)-6(a)(3) states that the sale of property is **not** subject to SE tax **unless** at least **one** of the following conditions apply.

1. The property is stock in trade or other property of a kind that would properly be includable in inventory if on hand at the close of the tax year.

2. The property is held primarily for sale to customers in the ordinary course of a trade or business.

As noted previously, the regulations specifically prohibit the use of the de minimis safe harbor election for property that is held as inventory for resale.[107] Therefore, no purchased livestock expensed under the de minimis safe harbor meets the first condition. Whether purchased livestock are held primarily for sale to customers in the ordinary course of a trade or business depends on the fact of each situation. If the livestock whose purchase cost was deducted under the de minimis rule are **not** held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, then the resulting gain on the sale is **not** subject to SE tax.

Treas. Reg. §1.1402(a)-6(a) also says that for purposes of subsection (3), it does not matter whether a gain or loss is treated as capital or ordinary income for other tax purposes when determining net earnings from self employment. Therefore, the conversion of the IRC §1231 gain to ordinary income in compliance with Treas. Reg. §1.263(a)-1(f)(3)(iii) does not convert the gain or loss into SE income.

Reporting the Gain. The instructions for Form 4797, *Sales of Business Property,* state that the form is used to report the "disposition of noncapital assets (other than inventory or property held primarily for sale to customers in the ordinary course of your trade or business)." They also state a sale is reported in **Part II** of Form 4797 if **both** of the following apply.

1. The transaction is **not** reported in Part I or Part III.

2. The property is **not** a capital asset, the sale of which would be reported on Schedule D, *Capital Gains and Losses*.

Because the regulations bar IRC §1231 treatment, the sale of property expensed under the de minimis safe harbor is not reported in Part I of Form 4797. Because there is no depreciation to recapture, the sale is not reported in Part III. Consequently, the sale is reported in Part II of Form 4797.

> **Note.** See the 2016 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues, for examples of reporting the gain in this situation.

107. Treas. Reg. §1.263(a)-1(f)(2)(i).

Including Gains in SE Income

Reasoning. An item that was previously expensed as a supply item is not an IRC §1231 (or IRC §1221) asset. Therefore, if the item is sold, the gain is included in "other income" in the same manner as other recovery items. Income from recovery items has the same characterization as the original expense. For example, non-commodity receipts would be included in other income for Schedule F purposes when the original tax benefit was claimed on Schedule F.

Reporting the Gain. An item that is not an IRC §§1221 or 1231 asset must be reported by a sole proprietor as ordinary income on the Schedule C or Schedule F, where it is subject to SE tax.

> **Example 20.** Terry, a hog producer, bought 100 gilts at $150 per head and used the de minimis safe harbor election to claim a Schedule F deduction. Two years later these animals are culled at a sale price of $200 per head. The sale proceeds are reported as Schedule F ordinary income where they are subject to SE tax. The $50 gain per animal above the original purchase price does not receive capital gain treatment. [108]

> **Note.** Similar to purchased gilts, purchased dairy heifers generally qualify for IRC §1231 treatment.[108] However, if the de minimis election is made to claim a Schedule F deduction for their cost, the heifers cannot be treated as IRC §1231 assets. Therefore, the same tax result is obtained on their later sale as was obtained in the example.

SUMMARY

Is it a sound tax strategy to utilize the de minimis safe harbor for these purchases of livestock? The same tax results can often be achieved in the year of purchase by using the IRC §179 deduction and/or bonus depreciation. Under these options, if the selling price exceeds the original purchase price, the excess gain is given capital gain treatment. In addition, there is no SE tax on sale, and the ordinary income recapture is limited to the original cost of the animals.

In contrast, the entire gain is given ordinary income tax treatment if the de minimis safe harbor election is used to deduct the purchase of the livestock. Use of the de minimis election may be uniquely detrimental to livestock producers who sell the animals at the end of breeding use, because the income from these sales may be significant.

It appears that the IRS may determine that SE tax does not apply to gains from the sale of assets that were expensed under the de minimis safe harbor election. However, at the time of this publication there is no authoritative guidance from the IRS on this issue. Therefore, until the IRS takes a definitive stand, it may not be worth the risk that the IRS will later determine that the gains are subject to SE tax when other expensing methods are available.

AGRICULTURAL RULINGS AND CASES

Hobby vs. For Profit

***Roberts v. Comm'r,* U.S. Court of Appeals, 7th Circuit; No. 15-3396 (Apr. 15, 2016)**

☞ Appellate Court Says Profit Intent Present For All of the Years Involved in Horse Activities

Facts. Merrill Roberts bought an abandoned restaurant building in the late 1960s and operated it successfully until a kitchen fire shut it down. Mr. Roberts later reopened the business as a bar, which eventually became a strip club. He sold that business for moral reasons and opened a pizza parlor about five miles away. He later reclaimed the strip club because the buyer defaulted on payments. Having reconciled his moral concerns, he continued to operate the club successfully and opened other strip clubs and restaurants. He also participated in strip club trade organizations.

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108. IRC §1231(a)(3)(A)(i).

In the late 1980s, Mr. Roberts bought farmland adjacent to the strip club. In the late 1990s, he bought additional farmland near the strip club on which a horse stable was located. With the purchases, Mr. Roberts created a 95-acre contiguous tract.

Mr. Roberts relinquished control of the strip club businesses to his children and started an insulation business and a used car dealership. He ultimately terminated involvement in both of those businesses and turned the 95-acre tract into a horse training facility to support his interest in horse racing.

Mr. Roberts expanded the horse activity and obtained a trainer's license. He later had disagreements with county officials about building codes and his horse activities. He ultimately sold the 95-acre tract in 2005 to an unrelated party for $2.2 million in a part-sale, part like-kind exchange transaction.

In 2006, Mr. Roberts bought a 180-acre parcel 16 miles from his home for horse-related activities and built a first-class training facility. He was deeply involved in the activities. In the early years of his activities, his deductions far exceeded his income due in part to disease and death of numerous horses. His cumulative losses over four years were slightly less than $1.5 million.

Issue. The issue in this case is whether the taxpayer operated his horse-related activities as a business or as a hobby, which would limit his allowable deductions.[109]

Analysis. To determine whether an activity is engaged in for profit, courts utilize a 9-factor analysis in accordance with Treas. Reg. §1.183-2(b). Initially, the Tax Court determined the following with respect to Mr. Roberts's horse activities.

1. He conducted the horse activities in a business-like manner.
2. He consulted experts.
3. He invested significant time in the activities.
4. He had a legitimate expectation that the new property would appreciate in value.
5. He had successfully conducted other activities that were relevant to an expectation of profit in the horse activities.
6. He had a legitimate expectation of future profit.
7. He was not an "excessively wealthy" individual.
8. He had elements of personal pleasure or recreation for only the first two of the four tax years under review.
9. His situation was neutral on the history of income or losses with respect to the activity.

The court noted that while Mr. Roberts started the horse activities without a profit objective, he turned that activity into a profitable one. As a result, the Tax Court concluded that **he had the requisite profit intent for the last two years at issue but not the first two years.** The accuracy-related penalty was not imposed, but the petitioner was liable for additions to tax for one of the tax years under review.

Holding. On appeal, the 7th Circuit Court of Appeals **reversed** the Tax Court's decision. The court stated that the Tax Court's conclusion was untenable inasmuch as the Tax Court opinion amounted to saying that a business's start-up costs are not deductible business expenses. Following the Tax Court's reasoning, every business starts as a hobby and becomes a business only when it achieves a level of profitability. The appellate court stated that the Tax Court's finding that the petitioner's land purchase and improvements were irrelevant to the issue of profit motive until he began using the new facilities is "unsupported and an offense to common sense." Thus, the petitioner had a profit intent for 2005 and 2006 also.

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109. IRC §183(a).

Hobby vs. For Profit

***Estate of Stuller v. U.S.*, U.S. Court of Appeals, 7th Circuit; No. 15-1545 (Jan. 26, 2016)**

☞ Horse Breeding and Training Activity Not Engaged in With Profit Intent

Facts. Wilma and Harold Stuller operated numerous Steak 'n Shake franchises. They later began breeding and training Tennessee Walking Horses and formed an S corporation for the horse activity. They personally owned a farm that they rented to the S corporation to conduct the horse activities.

After Mr. Stuller died in a 2003 fire at their Springfield, Illinois home, Mrs. Stuller became president of the corporation that ran the franchises and was very involved in the franchise businesses. Before Mr. Stuller died, they experienced substantial losses from the horse activity from 1994 to 2009, losing money every year except 1997, when they made a profit of $1,500. The only way the horse activity was able to continue was because Mr. and Mrs. Stuller loaned approximately $1.5 million to the activity.

The S corporation's returns for tax years 2003–2005 had total losses of about $430,000, which the Stullers deducted on their personal tax returns. The IRS examined the returns and denied the deductions. Mrs. Stuller paid the additional tax and sued for a refund.

Issue. The issue in this case is whether the taxpayers operated the horse-related activities as a business or as a hobby, which would limit the allowable deductions.[110]

Analysis. To determine whether an activity is engaged in for profit, courts utilize a 9-factor analysis in accordance with Treas. Reg. §1.183-2(b). The court noted that under the multi-factor analysis, Mr. and Mrs. Stuller (and later Mrs. Stuller) did not meet the requirements for the activity to be considered engaged in for profit. In making its decision, the court noted the following.

1. The taxpayers did not substantially alter their methods or adopt new procedures to minimize losses.
2. The taxpayers did not get the advice of experts.
3. The taxpayers continued to operate the activity while incurring the losses, and the losses existed long after the expected start-up phase would have expired.
4. The taxpayers' profits were minimal.
5. The taxpayers had substantial income from the franchises.
6. The widow had success in other ventures that were unrelated to horse activities.

The district court **upheld** the IRS's determination that the horse activity was not engaged in with a profit intent. Mrs. Stuller moved to amend the judgment to reduce the couple's taxable income by the amount of rental income that they received from the S corporation but the court denied the motion.

Holding. The 7th Circuit Court of Appeals **affirmed** the District Court's decision, noting that none of the nine factors of Treas. Reg. §1.183-2(b) favored the couple. The appellate court also ruled that the inability to deduct the losses that the S corporation sustained did not alter the fact that an S corporation is a separate entity from its shareholders. Thus, the inability of the couple to deduct the losses from the S corporation's horse activities did not entitle them to exclude the rental income from their personal return.

110. IRC §183(a).

Tax Liens

U.S. v. Sanders, **No. 3:11-cv-00912; U.S. District Court for the Southern District of Illinois (Feb. 18, 2016)**

☞ IRS Can Sell Farmland Held in Trusts of Tax Protester to Pay Tax Debt

Facts. Frankie Sanders is a self-employed farmer who failed to file federal tax returns or pay federal taxes beginning in 1991 on the belief that he had no obligation to pay taxes on his income. The IRS audited Mr. Sanders, who did not cooperate with the IRS throughout the audit process. As a result, the IRS estimated his income and expenses based on USDA data for the years at issue.

After the audit began, Mr. Sanders transferred his personal and real property to various "pure" trusts. Under the trusts' terms, the trusts held title to the property and Mr. Sanders had no right to manage the property. The IRS filed liens against the farmland that Mr. Sanders had placed in the trusts.

The IRS asserted that his tax liability for the years 1991–1997 was over $441,000, including penalties and interest through the end of 2015. The IRS sought a judgment for that amount. The IRS also sought a judgment that Mr. Sanders's tax liabilities constitute a valid lien on his property (which includes farmland) and that the IRS could enforce the lien via foreclosure and sale of the property.

Issue. The issue in this case is whether the IRS can enforce a lien for back taxes by foreclosing and selling Mr. Sanders's property.

Analysis. The court determined that Mr. Sanders could not object to the IRS estimates of his tax liability because he failed to cooperate with the IRS during the audit process. The court also held that Mr. Sanders retained ownership rights to the farmland transferred to the trusts, thereby allowing the IRS to seize the farmland and sell it to pay his tax debt. The court noted that the trusts were simply Mr. Sanders's nominee. Indeed, at least with respect to one of the trusts, he was the sole trustee and the sole beneficiary. He retained possession and control of the farmland and continued to derive income from the farmland. The court also noted that Mr. Sanders's legal counsel had been suspended for six months for making frivolous tax arguments on behalf of himself and clients.

Holding. The court held that the government is entitled to judgment that the federal tax liens against Mr. Sanders's property are enforceable. Accordingly, Mr. Sanders is liable for income tax liabilities of $441,846 for the 1991–1997 tax years, and his farmland could be sold to pay that debt.

Tax-Exempt Organization

Ltr. Rul. 201601014 (Oct. 7, 2015)

☞ No Tax-Exempt Status for Farmer's Market

Facts. A farmer's market operated a marketplace where farmers and others could sell products directly to the public. The market also set up special events where local craft vendors could sell goods, hold cooking demonstrations, and conduct educational programs. Its stated purpose was to strengthen the natural products economy, contribute to healthy lifestyles, and support other charities.

Holding. The IRS denied the market's IRC §501(c)(3) application on the basis that the market provided space for private businesses to sell their products, which is in violation of Treas. Reg. §1.501(c)(3)-1(d)(1)(ii). Thus, the market was organized for the substantial purpose of providing private benefits to vendors of products at the market, which violated its charitable tax status. The IRS determined that the facts involved were basically the same as those mentioned in Rev. Rul. 71-395.

Agricultural Cooperatives

Ltr. Rul. 201601004 (Sep. 28, 2015)

☞ Ag Cooperative Joint Venture Generates DPAD Ruling

Facts. An agricultural cooperative provides various products and services to members. It also markets grain raised by its members. The taxpayer considered combining its grain marketing function with another cooperative. To facilitate the joint marketing function, an LLC taxed as a partnership was proposed to be formed with each cooperative receiving a fixed percentage interest in the LLC. Each cooperative's distributive share of partnership net gain or loss would be based on the fixed percentage. The taxpayer sought IRS guidance on the various tax aspects of the proposal.

Holding. The IRS determined the following.

- The taxpayer's distributive share of net income or loss from the LLC that was attributable to marketed grain on behalf of members would be patronage-sourced.
- Grain payments to members (and participating patrons) would be "per-unit retains paid in money" (PURPIMs).
- The taxpayer will be treated as having manufactured, produced, grown, or extracted the grain it purchased from its members and participating patrons and thus would qualify for an IRC §199 domestic production activities deduction. The deduction will be computed without regard to any deduction for the grain payments made to members and participating patrons.

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Self-Employment Income

Methvin v. Comm'r, **U.S. Court of Appeals, 10th Circuit; No. 15-9005 (Jun. 24, 2016)**

☞ Oil and Gas Income Considered Partnership Income Subject to Self-Employment Tax

Facts. Mr. Methvin was a CEO of a computer company. He had no knowledge or expertise in oil and gas drilling or extraction. In the 1970s, Mr. Methvin acquired **working interests** of 2–3% in several oil and gas ventures.

The ventures were not part of any business organization; instead, they were established by a purchase and operating agreement with the actual operator of the interests. The operator managed the interests and allocated income and expense to Mr. Methvin based on his ownership. Mr. Methvin had no right to be involved in the daily management or operation of the ventures. Under the agreement, the owners of the interests elected to be excluded from subchapter K of the Code (which contains the rules governing partnership taxation) under IRC §761(a).

Mr. Methvin had the right to audit the books and records and to inspect:

- Receipts,
- Vouchers,
- Insurance policies,
- Legal opinions,
- Drilling logs and reports,
- Copies of drill stem tests,
- Core analyses,

- Electrical surveys,
- Geological reports, and
- Other records involving wells that had been drilled.

Mr. Methvin shared these rights and the costs with the operator. He was responsible for monthly costs in proportion to his share of the working interests.

In 2011, Mr. Methvin's interests generated almost $11,000 of revenue and approximately $4,000 of expenses. The operator classified the revenues as nonemployee compensation and issued Mr. Methvin a Form 1099-MISC, *Miscellaneous Income.* The operator did not issue a Schedule K-1, and the ventures did not file a Form 1065, *U.S. Return of Partnership Income*.

Mr. Methvin reported the net income as "other income" not subject to SE tax on line 21 of his Form 1040, *U.S. Individual Income Tax Return.* He believed that his working interests were investments and that he was not involved to the extent that the income from the activity constituted trade or business income. Mr. Methvin believed that he was not a partner because of the election under §761(a), so his distributive share was not subject to SE tax.

Issue. The issue in this case is whether Mr. Methvin's participation in the oil and gas ventures constituted a partnership interest subject to SE tax.

Analysis. The IRS agreed with Mr. Methvin's position in prior years but not for 2011. The IRS claimed that the income was partnership income that was subject to SE tax. The Tax Court agreed with the IRS because a joint venture had been created with the working interest owners (of which Mr. Methvin was one) and the operator. Thus, Mr. Methvin's income was partnership income under the broad definition of a partnership in IRC §7701(a)(2). The trade or business was conducted by Mr. Methvin's agents. Simply electing out of subchapter K did not change the nature of the entity from a partnership.

Holding. The 10th Circuit Court held that Mr. Methvin did not hold a limited partner interest that would not be subject to SE tax under IRC §1402(a)(13). The 10th Circuit also noted that the fact that the IRS had conceded the SE tax issue in prior years did not preclude the IRS from pursuing the issue in a subsequent tax year.

Profit Motive

***Embroidery Express,* LLC v. Commr, TC Memo 2016-136 (Jul. 21, 2016)**

☞ Taxpayers Did Not Prove Profit Motive in Resort Business

Facts. Brent and Lynette McMinn, a married couple, bought 176 acres of agricultural land on which to raise cattle. However, they changed their minds and decided to use the property for a deer hunting preserve. Upon learning of legal liability issues associated with a hunting preserve, the McMinns scrapped the plans for the preserve. The McMinns later improved a portion of the acres to create a lake resort.

Although substantial improvements were made to the land, the McMinns did not advertise the resort nor did they have a written business plan or any expertise in running a resort. The McMinns did not keep a separate bank account or books for the resort. In addition, they earned only limited and occasional income from the camping sites they created on the tract.

The McMinns filed Schedules F, *Profit or Loss From Farming,* for the years at issue, reporting losses from the entire 176 acres. However, they limited their depreciation deductions to account for personal use of the resort property.

The McMinns employed their children in the family embroidery business. They claimed business expense deductions for wages paid to four of the children. For the three years covered by the case, they paid total compensation to these four children of $46,516, $50,913, and $64,650. Substantial yearend bonuses were included in the wages. The bonuses were based at least partially on the performance of the embroidery business.

The McMinns donated a significant amount of money and noncash goods to various charitable organizations during the years at issue. Mr. McMinn also traveled to Jamaica as part of a mission trip. The costs of the trip and the donations were deducted by the taxpayers.

The IRS determined deficiencies totaling nearly $350,000 for the years 2004 through 2006. The IRS also assessed accuracy-related penalties of over $64,000.

Issues. Several issues were presented in this case. The analysis that follows focuses on:

- Whether the McMinns operated the cattle, deer, and resort activities with a profit objective;
- Whether the taxpayers' children were paid reasonable compensation for the services they provided;
- Whether they complied with all the requirements to deduct their charitable contributions; and
- Whether the 20% accuracy-related penalty applies.

Analysis. The court analyzed the **profit-motive** tests found in Treas. Reg. §1.183-2(b)(1) in connection with the McMinns' cattle and deer activity and their resort and agreed with the IRS on most counts. The following factors were among those that the court found notable.

- The McMinns did not conduct the activities in a businesslike manner. The lack of business plans, advertising, and separate books, records, and bank accounts for the resort activity all reflected poorly on the taxpayers' profit motive. Significantly, the McMinns did not purchase or raise any deer or cattle.
- The McMinns had no prior experience in operating a resort or raising deer, although as a child, Mr. McMinn did have experience raising cattle on his family ranch. The fact that his experience led him to conclude prior to claiming the losses that the activity would not generate a profit supported the IRS's claim that Mr. McMinn did not have a profit motive.
- The McMinns did not devote much time to the activities, and very little income was produced from the activities. They also had substantial income from other sources, which indicates they could afford a hobby with losses that offset other income.
- The elements of personal pleasure and recreation weighed heavily against the McMinns. Their residence was surrounded by the land used for the cattle and deer activity. They built a personal residence near the resort's lake and used the lake for personal pleasure.
- The only factor that favored the McMinns was the expectation that the assets would continue to increase in value. The court found that this factor was insufficient in comparison to the factors that were decided in favor of the IRS.

The court closely scrutinized the **wages paid** to the children to determine whether there was a bona fide employer-employee relationship. The court also considered whether payments were made for services actually performed for the business. The court found Mr. McMinn's testimony credible concerning the work that the children performed. This testimony was supported by unrelated parties. Therefore, despite the lack of proper documentation concerning the children's time and efforts, the court determined that the small payments during the year were reasonable compensation.

However, the court found that the large bonuses issued at yearend were not typical of a bona fide employer-employee relationship but were partially for support of the McMinns' dependent children. The McMinns were unable to establish that a similar amount would have been paid to an unrelated party. In addition, there was no written plan in place at the beginning of the year setting forth the conditions for a bonus to be paid at yearend.

The court examined the requirements that must be met to deduct **charitable contributions.** For each contribution at issue, the court considered whether:

- The organization was a qualified U.S. charity,
- The donation was given directly to an individual,
- Proper substantiation was maintained,
- The fair market value of donated items was properly determined, and
- The necessary written acknowledgments were received.

The court found that some of the charities were nonqualifying. In addition, the taxpayers did not have the required written acknowledgements for all of the contributions, the out-of-pocket expenditures lacked substantiation, and the taxpayers failed to get an appraisal for items valued at over $5,000.

The court considered Mr. McMinn's level of education and his reliance on advisors to determine if the **accuracy-related penalty** under IRC §6662 should be imposed. It is not imposed to the extent the taxpayer can show that there was reasonable cause for the underreporting and that the taxpayer acted in good faith with respect to such portion. The court found that the taxpayers reasonably relied on their bookkeeper and CPA in the preparation of their returns. Accordingly, the court determined that the taxpayers acted with good faith and reasonable cause.

Holdings. The court made the following determinations.

- The court disallowed the losses from the cattle, deer, and resort activities on the basis that the activities were not conducted with a profit intent in accordance with Treas. Reg. §1.183-2.
- The court disallowed all but a small portion of the yearend bonuses paid to the taxpayers' children. The court allowed the smaller payments made periodically through the year as reasonable compensation for bona fide services provided.
- The court disallowed most of the McMinns' charitable contributions.
- The court determined that the taxpayers were not negligent and therefore not subject to the 20% accuracy-related penalty.