Chapter 5: Agricultural Issues and Rural Investments

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Please note. Corrections were made to this workbook through January of 2018. 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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Chapter Summary

Current IRS audit issues are examined, including the following.

- An IRS pilot study is designed to identify possible "hobby" farmers by targeting taxpayers who have high Form W-2 income and who file a Schedule F but "may not have the time to run a farm."
- Generally, rental income from farm leases does not create self-employment (SE) income. However, there is an exception if certain criteria are met.
- Employer-provided meals and lodging may be excludable from an employee's income. However, they should be accepted as a condition of employment and be for the convenience of the employer on the employer's business premises.

Proposed corporate tax rate reductions may fuel renewed interest in C corporations. However, businesses contemplating incorporation should be wary of exposure to the accumulated earnings tax and personal holding company tax.

Farmers using the cash method of accounting often deduct prepaid expenses. Recent court cases in which the IRS denied current deductions, contending that they should be taken in the year the items were consumed, are reviewed.

Farm animals and plants having more than a 2-year preproductive period are affected by the uniform capitalization rule. Relevant tax issues are covered, including the tax consequences of the election to avoid capitalization of preproductive costs.

A key question for a farmer/rancher is whether livestock should be depreciated or included in inventory. There are several benefits of capitalization. For example, depreciation reduces the farmer's income, favorable capital gains tax rates apply to business assets held for more than one year, and associated depreciation recapture may not be subject to SE tax.

Hoop structures are used by farmers to house livestock or store agricultural commodities or machinery. Various tax planning opportunities are explored to save or defer taxes on asset sales and exchanges. Bonus depreciation and expensing under IRC §179 are also addressed.

Farmers have the option to average income from the three preceding years to determine the tax rate applicable to the election year. Tax planning opportunities can arise from the interplay between income averaging, the two or five year net operating loss carryback provisions, and prior year IRC §179 election revocation. Using Schedule J to manage farm income is also covered.

Livestock Indemnity Program payments are set at 75% of the market value of livestock the day before their death. Payment limitations, income deferral, documentation, and tax reporting issues are addressed.

Finally, the chapter examines farmers' eligibility for Chapter 12 bankruptcy filing, along with the tax consequences associated with debt forgiveness.

IRS AUDIT ISSUES IN AGRICULTURE

HOBBY FARMS

IRS Pilot Program[1]

In March 2017, the IRS issued interim guidance on a pilot program for correspondence examinations of expenses reported on Schedule F, *Profit or Loss From Farming.* The examinations will be conducted by the IRS's Small Business/Self-Employed division. Beginning April 1, 2017, and running for one year, the focus will be on "hobby" farmers, and will be conducted through the IRS Brookhaven campus in Holtsville, New York. While the pilot will only consist of an examination of 50 tax returns from tax year 2015, it could be an indication that the IRS is considering increasing the audit rate of returns with a Schedule F. However, even if the pilot program indicates a widespread problem, it is uncertain whether the IRS will have the funds to conduct audits.

> **Observation.** Although it is unknown how returns will be selected for examination, it may be more likely to impact smaller farming operations.

The interim guidance indicates that the IRS believes compliance issues may exist regarding deducting expenses on the wrong form, that actually belonged to another taxpayer, or that should be subject to the hobby loss rules of IRC §183. The IRS notes that a filter for the project will be designed to identify those taxpayers who have significant income reported on Forms W-2, *Wage and Tax Statement,* and also individuals who file a Schedule F "and may not have the time to run a farm." The IRS also states that the filtering for expenses will be via the same process that it uses when it examines Schedules C, *Profit or Loss From Business.* It notes that deductions relating to a taxpayer's W-2 employment; Schedule A, *Itemized Deductions;* or a corporate return are not deductible on Schedule F. In addition, the guidance informs IRS personnel that the examined returns could have start-up costs or be a hobby activity, which would lead to nondeductible losses.

The interim guidance directs the IRS examiners to consult IRS Pub. 225, *Farmer's Tax Guide,* and look for taxpayers whose primary residence is on a farm and whose principal business is farming. The interim guidance also directs examiners to look for deductions that "appear to be excessive for the income reported."

> **Observation.** The implication is that such expenses are not deemed ordinary and necessary business expenses. It is uncertain how that might impact the practice of prepaying farm expenses.

One of the tests for prepaying and deducting farming expenses is that the prepayment must not materially distort income. The interim guidance seems to imply that the IRS views a high amount of prepaid expenses when income is relatively low to be a material distortion of income. The guidance states that deposits are not deductible prepayments, although a deposit for "future supplies" is deductible.

> **Note.** A prepayment that constitutes a deposit is not deductible in accordance with Rev. Rul. 79-229, which the guidance does not mention. However, the guidance indicates that a prepayment cannot be a deposit and that a taxpayer must document the reason for the prepayment.

1. *Memorandum for Director, Examination – Campus.* Feb. 27, 2017. IRS. [www.irs.gov/pub/foia/ig/spder/sbse-04-0217- 0014redacted.pdf] Accessed on Apr. 22, 2017.

The IRS instructs its examiners to separate deductible business expenses from capital expenses and personal expenses. With regard to capital expenses, the guidance does not mention the $2,500 safe harbor (per invoice or per item), which allows a current deduction.[2] The guidance also instructs examiners to review gas, oil, fuel, repairs, etc., to determine the "business and nonbusiness parts" of the expense. Again, no mention is made of the $2,500 safe harbor.

The interim guidance states that custom hire expenses are deductible on line 13 of Schedule F. It also notes that fuel is deductible if it is used for conducting business on the farm. The IRS instructs examiners to inquire about on-farm storage tanks and how the taxpayer accounts for personal use of fuel. Fuel purchased from a gas station needs further explanation to ensure the taxpayer did not use it for personal purposes.

The interim guidance notes that mortgage interest is deductible if it relates to real property that is used in the taxpayer's farming business. The guidance also states that repair and maintenance expenses on the taxpayer's personal residence are not deductible. However, it does not mention deductions for repairs and maintenance on a home office, which is a common agriculture situation.

Observation. The interim guidance appears to be targeted toward taxpayers who either farm or crop share some acres for which the income is reported on Schedule F but who have predominately nonfarm sources of income (e.g., W-2 income, income from leases for hunting, bed and breakfasts, conservation reserve program payments, organic farming, etc.). In those situations, it is likely that the Schedule F expenses exceed the Schedule F income. This is particularly the case when a taxpayer claims depreciation on items associated with the farm (e.g., a small tractor, all-terrain vehicle, pickup truck, etc.). This is the typical hobby loss scenario that the IRS is apparently looking for.

FARM RENTAL INCOME AND SELF-EMPLOYMENT TAX

The IRS continues to audit agricultural rental arrangements for self-employment (SE) tax. In general, rental income from farm leases (whether cash rents or crop-shares) does not create SE income. However, depending on the landlord's level of participation, this rental income may be subject to SE tax.

Mizell v. Comm'r[3]

Lee Mizell had been a farm proprietor; but in 1986, he formed a farm partnership with his three sons, with each partner holding a 25% ownership interest. The separate leasing of land to the partnership began in 1988, when Mizell leased 730 acres to the partnership. The lease called for Mizell to receive a one-quarter share of the crop, and the partnership was responsible for all expenses. Mizell reported his 25% share of partnership income as SE earnings. However, the crop-share rent on the land lease was treated as rental income that was exempt from SE tax.

Upon examination, the IRS assessed SE tax on the crop-share lease income for the years 1988, 1989, and 1990. Both the IRS and Mizell agreed that he materially participated in the agricultural production of his farming operation. The IRS took the position that the crop-share rental and the farming partnership constituted an arrangement that needed to be considered in the aggregate in measuring SE income. Mizell argued that the crop-share lease did not involve material participation and that the crop-share rental income should be exempt from SE tax.

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2. Amounts paid to acquire or produce tangible property that do not exceed a certain dollar threshold may be deducted under a de minimis safe harbor. (See IRS Notice 2015-82, 2015-50 IRB 859 and Treas. Reg. §1.263(a)-1(f)(1)(ii).) For farmers without an applicable financial statement (which includes most of them), the safe harbor is $2,500. The taxpayer bears the burden of showing that deducting amounts in excess of the threshold does not distort income.

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

Generally, rentals from real estate (and personal property leased with real estate) are excluded from the definition of SE income.[4] There is an exception, however, for farmland rental if the following three criteria are met.[5]

1. The rental income is derived under an arrangement between the owner and lessee that provides that the lessee will produce agricultural commodities on the land.
2. The arrangement calls for the material participation of the owner in the management or production of the agricultural commodities.
3. There is actual material participation by the owner.

The Tax Court focused on the word "arrangement" in both the statute and the regulations, noting that this implied a broader view than simply the single contract or lease for the use of the land between the landlord and tenant. By measuring material participation with consideration to both the crop-share lease and Mizell's obligations as a partner in the partnership, the court found that the rental income must be included in Mizell's net earnings for SE tax purposes.

Subsequent Guidance

The IRS privately ruled that a husband and wife in Wyoming who leased land to their agricultural corporation were subject to SE tax on the cash-rental income, because both the husband and wife were employees of the corporation. The IRS based its ruling on the *Mizell* opinion, continuing to argue that the use of the word "arrangement" in the first two criteria (mentioned earlier) is intended to convey a broad interpretation, such that other roles of the landlord (for instance, as an employee or as a participating partner) must be considered.[6]

Note. The IRS's view is that a taxpayer's role as a landlord cannot be separated from the taxpayer's role as an employee or partner.[7] Thus, the employee or partner-level participation by the landowner triggers SE tax on the rental income.

Note. The wording of Treas. Reg. §1.1402(a)-4(b)(2) appears to be broad enough to include income in any form — crop share or cash — if received in an arrangement that contemplates the landlord's material participation.

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4. IRC §1402(a)(1).
5. Treas. Reg. §1.1402(a)-4(b)(1).
6. TAM 9637004 (May 6, 1996).
7. *Mizell v. Comm'r,* TC Memo 1995-571 (Nov. 29, 1995); TAM 9637004 (May 1, 1996).

Additional Tax Court Cases

The Tax Court issued three additional opinions on whether farmland rentals are subject to SE tax when the landlord also participates as an employee of the tenant/farm operator.

- In *Bot v. Comm'r*,[8] the Tax Court concluded that rental income (at the rate of $90 per acre) received by Judy Bot for 240 acres of land, paid to her by her husband Vincent Bot's farm proprietorship, was subject to SE tax. The court construed her salary from Vincent's farm proprietorship, averaging about $15,000 per year, to be part of a single arrangement that included the lease. The court noted that Mrs. Bot had performed approximately 1,900 hours of farming services per year for 38 years. The court also noted that Mrs. Bot's employment agreement and salary only began in 1992.
- In *Hennen v. Comm'r,*[9] the Tax Court again held that SE tax must be imposed on rental income received by a wife on 200 acres of land leased to her husband's farm proprietorship. The wife worked about 1,000 hours in the farming operation per year and received a salary of about $3,500 per year.
- *McNamara v. Comm'r*[10] involved a married couple who owned 460 acres that they leased to their farming C corporation under a cash-rent written lease, with payments averaging approximately $50,000 per year. The husband was employed full-time by the corporation, and the wife was employed part-time doing bookkeeping and farm errands. Her annual compensation was approximately $2,500 per year. Again, the Tax Court held that the rental arrangement and the employment roles were to be treated as one, and the rental income was subject to SE tax.

The three Tax Court cases were consolidated on appeal at the 8th Circuit. The 8th Circuit reversed all three Tax Court opinions and remanded the cases to the Tax Court for the purpose of giving the IRS an opportunity to illustrate that there was a connection between the rental amount and the labor arrangement.[11] There was no connection, primarily because the rents were cash rents that were slightly below fair market value (FMV).

The 8th Circuit focused on the taxpayers' argument that the lessor-lessee relationship should stand on its own, apart from the employer-employee relationships. The 8th Circuit interpreted IRC §1402(a)(1) as requiring material participation by the landlord in the rental arrangement itself in order to subject the arrangement to SE tax. The court stated that "the mere existence of an arrangement requiring and resulting in material participation in agricultural production does not automatically transform rents received by the landowner into SE income. It is only where the payment of those rents comprise part of such an arrangement that such rents can be said to derive from the arrangement."

Note. The IRS issued an Action on Decision, recommending nonacquiescence to the *McNamara* case in jurisdictions outside of the 8th Circuit.[12] However, within the 8th Circuit, the IRS indicated that it will follow the *McNamara* decision and not attempt to assert a connection between a labor agreement and a land lease, assuming the facts indicate conformity to fair rental value under the lease and reasonable wages. The 8th Circuit is composed of Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota.

8. *Bot v. Comm'r,* TC Memo 1999-256 (Aug. 3, 1999).

9. *Hennen v. Comm'r,* TC Memo 1999-306 (Sep. 16, 1999).

10. *McNamara v. Comm'r,* TC Memo 1999-333 (Oct. 4, 1999).

11. *McNamara v. Comm'r*, 236 F.3d 410 (8th Cir. 2000), *rev'g McNamara v. Comm'r,* TC Memo 1999-333 (Oct. 4, 1999).

12. AOD CC-2003-03 (Oct. 21, 2003). The IRS reiterated its opposition to McNamara in a letter to Sen. Mark Kirk of Illinois, stating that it intends to continue to litigate the issue in cases outside the 8th Circuit. The letter is found at [www.irs.gov/pub/irs-wd/12-0035.pdf.]

In *Johnson v. Comm'r,*[13] the taxpayers farmed in southern Minnesota and leased 617 acres of land to their farm corporation. Their lease with the corporation was verbal, as was their employment agreement with the corporation. For the three years at issue (1993–1995), the salary paid by the corporation was nominal. Mr. Johnson received $1,000 of compensation in one year and nothing in the other two years. The rental payments were $66,715 in 1993, $60,000 in 1994, and $104,878 in 1995. There was no additional land under lease in 1995.

The IRS's position acknowledged the 8th Circuit's *McNamara* opinion, noting that rents are not subject to SE tax "when the landlord has two independent arrangements with the lessee for rent and wages and there is no nexus between the two arrangements." However, the IRS asserted that the withdrawal by the Johnsons of virtually all funds from the corporation as rent indicated that two separate arrangements did not exist.

Immediately prior to the trial, the Johnsons conceded that $44,878 of the 1995 rent of $104,878 should be reclassified as services and subjected to SE tax. The 1995 rent was reduced to an FMV amount consistent with the preceding years.

The Tax Court concluded that the rental arrangement, as adjusted for 1995, represented FMV amounts for all three years and that the rental payments were independent of any service requirements by the individuals. In the court's view, the rental payments stood on their own, because the individual taxpayers "were not obligated or compelled to perform petitioner's farm-related activities in the production of (the corporation's) agricultural commodities as a condition to the company's being obligated to pay rent to petitioner pursuant to the overall rental agreement."

Observation. The outcome in the *Johnson* case illustrates the importance of maintaining rental payments at market value amounts. Paying excessive rents, while also understating compensation, allows the IRS to argue that the rents represent disguised compensation.

In *Solvie v. Comm'r,*[14] the Solvies leased real estate to their controlled corporation and also received compensation as employees of the corporation. The compensation paid to the husband and wife together was $31,650 in 1993, $22,000 in 1994, and $20,800 in 1995. The rent paid by the corporation to the Solvies was straightforward for two of three years and did not involve a proposed IRS adjustment. For the first two years, the Solvies received land and building rents from their corporation of $50,400 per year. In 1995, in addition to the base rent of $50,400, additional rent was paid to the Solvies for a newly constructed hog barn, with the rent paid at the rate of $21 per head for each hog rotated through the building. This increased the rent paid in 1995 by $44,500.

The IRS imposed SE tax for 1995 only, asserting that the new hog barn rent represented SE income to the Solvies. The IRS argued that the *McNamara* standard was not applicable because the Solvies had not established a fair rental value for the new hog barn nor had they established that a separate employment agreement existed for their additional labor in this facility. The IRS's view was that the classification of all funds paid by the corporation for the new hog barn in 1995 as rent, rather than as wages, demonstrated that there were no independent arrangements regarding the real estate rental and compensation for services in this hog barn.

13. *Johnson v. Comm'r,* TC Memo 2004-56 (Mar. 9, 2004).

14. *Solvie v. Comm'r,* TC Memo 2004-55 (Mar. 9, 2004).

The Tax Court concluded that the 1995 rent paid for the new hog barn of $44,500 represented SE income to the Solvies. Three factors led the court to this conclusion.

1. The rent the Solvies collected for the new hog barn was more than double the rent they collected from the corporation on their other buildings, and those buildings had a slightly greater hog production capacity than the new building.

2. The 1995 wages paid by the corporation to the Solvies did not increase, despite the extra hog production.

3. The new hog barn rent was calculated on a per-head basis, meaning that the Solvies would not have received any rent for the facility if the corporation was not processing hogs through that barn. A volume-based payment implies that the lease is more than just consideration for the use of property and includes some consideration for services.

Observation. If the Solvies had structured the $44,500 of rent that they drew from the corporation in connection with the new barn partially as a fixed rental payment and partially as increased salary, they likely would have prevailed in this case. However, because they received the rent as a per-head amount and took no extra compensation for their increased labor, the IRS pursued the issue through litigation.

Strategies in Response to Cases

Several planning strategies emerge from case law that can be utilized to minimize IRS audits on farm rental arrangements.

- Review client leases and consider the need for language within the lease that clarifies that the landlord is not providing any services or participation as part of the rental arrangement and that the tenant is fully responsible for production decisions and the use and control of the farmland during the lease term with no input from the landlord.

- Self-rental lease rates should be tied to market value for comparable land so that the IRS cannot argue that an arrangement involving the landlord's services exists.

- If the landlord is providing services, specify those duties in a separate written employment agreement that sets forth reasonable compensation for them.

MEALS AND LODGING FURNISHED TO EMPLOYEES

An IRS audit issue involving C corporation farming operations concerns meals and lodging furnished in-kind to an employee (including the employee's spouse and children). If the in-kind meals and lodging are furnished **for the convenience of the employer** on the **employer's business premises,** the amounts are excluded from the employee's gross income[15] and are fully deductible by the employer (as a noncash fringe benefit).[16] The value of meals and lodging is includable in an employee's income if the employee can choose to receive additional compensation instead of receiving the meals or lodging in-kind.

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15. IRC §119.

16. IRC §162; see *Harrison v. Comm'r,* TC Memo 1981-211 (Apr. 28, 1981)

Although in-kind meals and lodging are not considered employee compensation, they are deductible by the employer as an ordinary and necessary business expense.[17] With respect to employer-provided lodging, the employee must accept the lodging as a condition of employment.[18] In addition to being excluded from the employee's income, the value of meals and lodging furnished for the employer's convenience is not considered wages for FICA and FUTA tax purposes.[19]

Audit Issues Associated with Employer-Provided Meals

On the Business Premises. To be excluded from an employee's income, the meals must be furnished on the employer's business premises.[20] **Business premises** is defined as the employee's place of employment[21] where the employee performs a significant portion of their duties[22] or the employer conducts a significant portion of its business. Thus, the meals cannot be furnished at a convenient location that is merely near the place of employment.[23]

For the Convenience of the Employer. The meals must also be provided for the convenience of the employer. If they are not, the value of the meals is subject to FICA and FUTA taxes.[24] The key is that the meals (or lodging) must not be intended as compensation. An employment contract that fixes the terms of employment is not determinative by itself.[25] The same is true for a state statute.[26] In essence, the determination of the reason an employer provides meals and lodging to employees is based on objective facts and not on stated intentions. There must be some reasonable connection between providing employees with meals and lodging and the business interests of the employer.

Key Cases. In *Dobbe v. Comm'r,*[27] a farming C corporation operated on property that it leased from its shareholders/officers. The corporation required the corporate officers to be on the farm premises at all times to monitor activities and deal with issues as they arose. The corporation reimbursed the shareholders' grocery expenses. The shareholders' residence was on the farm and the meals were cooked in the shareholders' home. The Tax Court held that such an arrangement was for the shareholders' own convenience and not for the convenience of the employer. While the shareholders were engaged in day-to-day farm operations and may have eaten some meals while dealing with farm issues, the court held that they did so for their own convenience. In addition, the court pointed out that other employees were not treated similarly and the corporation failed to establish that the reimbursement was necessary to make sure that qualified employees would be available to address unexpected issues of the farm corporation. Also, it was not proved that the lease covered the residence on the property.

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

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

18. IRC §119(a)(2); Treas. Reg. §1.119-l(b)(3).

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

20. IRC §119(a)(1).

21. Treas. Reg. §1.119-l(c)(l).

22. Rev. Rul. 71-411, 1971-2 CB 103.

23. Ibid.

24. Rev. Rul. 81-222, 1981-2 CB 205; Ltr. Rul. 9143003 (Jul.11, 1991).

25. IRC §119(b)(1).

26. Ibid.

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

Another key case decided by the Tax Court in 2017 did not involve a farm or ranch taxpayer, but has important application to all taxpayers on the employer-provided meals issue.[28] In *Jacobs v. Comm'r,* the petitioners, a married couple, owned the Boston Bruins NHL franchise via three entities, the principal of which was an S corporation. During the hockey season, the team plays approximately one-half of its games away from Boston, throughout the United States and Canada. The players stay in hotels during the road trips, and the franchise contracts with the hotels to provide pregame meals to the players and team personnel.

The petitioners deducted the full cost of the pregame meals, and the IRS reduced the deduction in accordance with the 50% limitation.[29] The NHL has specific rules governing travel to out-of-town games that require a team to arrive at the away city the night before the game whenever the travel requires a plane trip of longer than 2.5 hours. To satisfy the travel requirement, the petitioners contracted with host city hotels for lodging and meals to be served in meal rooms. Player attendance at the meals is mandatory and specific food is ordered for the players to meet their specific needs.

The court noted that the 50% limitation is inapplicable if the meals qualify as a de minimis fringe benefit and are provided in a nondiscriminatory manner. The court determined that the nondiscriminatory requirement was satisfied because all of the staff that traveled with the team were entitled to use the meal rooms. The court also determined that the de minimis rule was satisfied if the eating facility (meal room) was owned or leased by the petitioner, operated by the petitioner, located on or near the petitioner's business premises, and the meals were furnished during or immediately before or after the workday.

In addition, the court noted that the annual revenue from the eating facility would need to normally equal or exceed the direct operating cost of the facility. The IRS conceded that the meals were provided during or immediately before or after the employees' workday, but claimed that the other requirements were not satisfied. However, the court determined that the petitioners did satisfy the other requirements on the basis that they can be satisfied via contract with a third party to operate an eating facility for the petitioners' employees.

As for the business purpose requirement, the court noted that the hotels where the team stayed while traveling for road games constituted a significant portion of the employees' responsibilities and was the location where the team conducted a significant portion of its business. The court also noted that the revenue/cost test is satisfied if the employer can reasonably determine that the meals were excludable from income under IRC §119 and are furnished for the employer's convenience on the business premises. The court determined that those factors were also satisfied. Thus, the cost of the meals qualified as a fully deductible de minimis fringe benefit.

Other Issues. Other issues that may arise during IRS examinations of employer-provided meals include the following.

- Cash meal allowances or reimbursements are includable in gross income to the extent the allowance constitutes compensation.[30] Therefore, the corporation should avoid having the arrangement cast as compensation by establishing in writing the business purpose in the corporate documents.
- Meal allowances provided on a routine basis for overtime work are not "occasional meal money" for purposes of the de minimis rules[31] and are treated as wages for FICA and withholding purposes (and presumably for FUTA as well).[32] Therefore, the corporation should exercise caution regarding arrangements for overtime.

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28. *Jacobs v. Comm'r,* 148 TC No. 24 (2017).

29. IRC §274(n)(1).

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

31. Treas. Regs. §§1.132-0 – 1.132-8

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

- The cost of groceries can be excluded from an employee's income.[33] This is particularly the case if the employee is required to live on the business premises as a condition of employment.

Note. The IRS does not agree with the court's conclusion in *Jacob v. U.S.*[34] that the cost of groceries can be excludable.[35] The Tax Court reached a different conclusion in *Tougher v. Comm'r*.[36] As a result, the IRS does not follow the 3rd Circuit Court's opinion in *Jacob* outside of the 3rd Circuit and takes the position in those jurisdictions that the value of such items is wages for FICA purposes.

The Tax Court got another chance to deal with the "groceries as meals" issue. In *Harrison v. Comm'r,*[37] two farm families incorporated a farming operation. They lived on the farm and were also corporate employees. The corporation purchased groceries that the farm wives used to prepare meals for all of the family members and hired help. The Tax Court found that the groceries counted as "meals" for purposes of IRC §119. The wives had a duty as employees of the corporation to buy the groceries and prepare meals that were then provided to all of the corporate employees. Construed in that light, the groceries were "meals."

- If employees have the option of **not** purchasing meals provided by the employer at a cost, the IRS has taken the position that the excess of FMV over the price of the meals purchased by employees is taxable income to the employees.[38]

Observation. If more than half of the employees to whom meals are provided on an employer's premises are furnished such meals for the convenience of the employer, then all of the meals are treated as furnished for the employer's convenience.[39] If this test is met, the value of all meals is excludable from the employee's income and is fully deductible by the employer.

Additionally, meals provided **without** lodging can also qualify under IRC §119 if they are consumed on the business premises. Thus, meals provided to farm employees in the field during harvesting and planting are covered. However, if the employees take a break and drive to town to eat meals, the costs are not deductible.

33. *Jacob v. U.S.,* 493 F.2d 1294 (3rd Cir. 1974).
34. Ibid.
35. See Ltr. Rul. 9129037 (Apr. 23, 1991).
36. *Tougher v. Comm'r*, 51 TC 737 (1969), *aff'd,* 441 F.2d 1148 (9th Cir. 1971).
37. *Harrison v. Comm'r,* TC Memo 1981-211 (Apr. 28, 1981).
38. Ltr. Rul. 7740010 (Jun. 30, 1977).
39. IRC §119(b)(4).

Audit Issues Associated with Employer-Provided Lodging

For the value of lodging to be excluded from the employee's gross income, the employer must furnish the lodging to the employee and the employee must be required to accept the lodging on the premises as a condition of employment and for the convenience of the employer.[40] The term **lodging** includes such items as heat, electricity, gas, water, and sewer service unless the employee contracts for the utilities directly from the supplier.[41] The term also includes household furnishings[42] and telephone services.[43]

Issues that may arise during IRS examinations of employer-provided **lodging** include the following.

- If the employee is required to pay for the utilities without reimbursement from the employer, the utilities are not furnished by the employer and are not excludable from income.[44]
- The lodging must be provided in-kind.[45] Cash allowances for lodging and meals are includable in gross income to the extent the allowance constitutes compensation.[46]
- The employee must accept the employer-provided lodging as a condition of employment.

> **Observation.** Acceptance of lodging as a condition of employment can only occur if the employee's acceptance of the lodging is necessary for the employee to properly perform their job duties. It is immaterial that the employee is required to accept the employer-provided lodging. The key is whether the employer-provided lodging is necessary for the performance of the employee's duties. It is an objective standard and it is immaterial, for example, that corporate documents (such as a board resolution) require the employee to live in corporate-provided lodging.[47]

- The employees must be required to accept the lodging on the employer's business premises.[48] Thus, both meals and lodging must be provided on the business premises.
- "Business premises of the employer" generally means the employee's place of employment.[49] It does not necessarily matter if the lodging is not physically contiguous to the actual business premises if the employee conducts significant business activities in the residence.[50]

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40. IRC §119(a)(2).

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

42. *Turner v. Comm'r,* 68 TC 48 (Apr. 21, 1977).

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

44. *Turner v. Comm'r,* 68 TC 48 (Apr. 21, 1977).

45. See Ltr. Rul. 9801023 (Sep. 30, 1997); Ltr. Rul. 9824001 (Feb. 11, 1998).

46. Treas. Reg. §1.119-1(e).

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

48. IRC §119(a)(2).

49. Treas. Reg. §1.119-1(c).

50. See, e.g., *Adams v. U.S.,* 585 F.2d 1060 (Fed. Cl. 1978).

> **Note.** Sometimes the IRS challenges the "business premises" issue when the meals and lodging are provided on premises that the corporation leases rather than owns. This should not be an issue, however.[51] The regulations state, "For example, meals and lodging furnished in the employer's home to a domestic servant would constitute meals and lodging furnished on the business premises of the employer. Similarly, meals furnished to cowhands while herding their employer's cattle on leased land would be regarded as furnished on the business premises of the employer."[52]

In most of the farm and ranch cases decided to date, whether the meals and lodging were provided "on the business premises" has not been an issue, but there are a few cases in which it has been an issue. The following cases illustrate this application in farm or ranch settings.

- In *Peterson v. Comm'r*,[53] the value of a home provided to the president of a poultry breeding corporation adjacent to the corporation's poultry farm was not excluded from income. The court acknowledged that "the facility in question was on the business premises of the employer," but the court held that the taxpayer was not required to live on the premises as a condition of employment and the taxpayer failed to show that the housing was furnished for the convenience of the employer.[54]
- In *Wilhelm v. U.S.*,[55] the value of food and lodging provided by a ranching corporation was not taxed to the shareholder-employees. The ranch was located in a remote location several miles from the nearest town. The court noted that the ranch was a grass ranch that put up very little hay and required constant attention by persons experienced in grass ranch requirements to keep cattle alive. The court also noted that during snowstorms the cattle needed to be fed daily, needed to be moved, waterholes had to be kept open, and the cattle had to be protected against the hazards of being trapped or falling into ravines. The court felt that the employees had no choice but to accept the facilities furnished by the corporate employer and that the food and lodging were furnished to the employees not only for the convenience of the employer, but that they were indispensable in order to have the employees on the job at all times.
- In *Caratan v. Comm'r*,[56] each shareholder-employee of a closely-held farm corporation lived in a corporation-owned house on the business premises. The taxpayers met the burden of proving that the lodging furnished to them was indispensable to the proper discharge of their employment. This was the case even though the corporation was located within a 10-minute drive from a residential area of a nearby town. The court reasoned that the issue was not the remoteness of the farm, but whether there was a good business reason to require the employees to reside on the premises.
- In *J. Grant Farms, Inc. v. Comm'r*,[57] the value of lodging and the cost of utilities of a married couple who managed and were the shareholders of a family farm was held to be excludable from their income because the manager's residence on the farm was necessary and a condition of employment in the swine-raising and grain-drying operation.

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51. *Dobbe v. Comm'r,* TC Memo 2000-330 (Oct. 25, 2000).
52. Treas. Reg. §1.119-1(c)(1).
53. *Peterson v. Comm'r,* TC Memo 1966-196 (Sep. 2, 1966).
54. IRC §119(a).
55. *Wilhelm v. U.S.,* 257 F.Supp. 16 (D. Wyo. 1966).
56. *Caratan v. Comm'r,* 442 F.2d 606 (9th Cir. 1971).
57. *J. Grant Farms, Inc. v. Comm'r,* TC Memo 1985-174 (Apr. 8, 1985).

- In *Johnson v. Comm'r*,[58] a married couple, as the sole shareholders of a corporation, were allowed an exclusion from income of the FMV of lodging in the corporate-owned residence located on the premises where the husband was the manager of the corporation's grain-drying and storage operation.
- In *Waterfall Farms, Inc. v. Comm'r*,[59] a corporate farming operation rented the residence where the taxpayer (who was a corporate shareholder, officer, and the sole corporate employee) lived. The shareholder-employee was provided food and lodging, but the court held that the amounts were not excludable because the corporation could not prove that substantial business activity occurred at the residence. The court determined that the food and lodging were not provided on the corporation's business premises. The fact that the corporation rented the residence was not material.
- In *Maschmeyer's Nursery, Inc. v. Comm'r*,[60] the petitioner, an agricultural nursery, provided its sole shareholder a residence at the nursery. The petitioner claimed that the shareholder's presence was necessary on a full-time basis as a security measure for the equipment and to oversee employees and handle shipments that came in after normal business hours. The Tax Court held that the provision of the lodging met the requirements of IRC §119.
- In 1994, the same court that decided *Wilhelm* in 1966 went further. In *Dilts v. U.S.*,[61] the court denied the exclusion for both meals and lodging (including groceries and utilities) for employee-shareholders of an S corporation.

What About Partnerships?

Generally, a partner is treated as a self-employed owner of the business rather than an employee. So, by its terms, IRC §119 does not apply. However, it can apply when a partner transacts with the partnership in a non-partner capacity.[62] The regulations say that this could occur in the rendering of services by the partnership to the partner or by the partner to the partnership.[63] A key case supporting the application of IRC §119 in the context of a partnership is *Armstrong v. Phinney.*[64] In a case involving a ranch partnership, the managing partner had to include amounts received from the partnership for meal reimbursements in gross income.[65]

C CORPORATION PENALTY TAXES

C corporations were very popular in agriculture in the 1960s and 1970s. Many farming operations were structured that way in those decades, and farmland was placed inside the corporation. With the advent of limited liability companies (LLCs) in the late 1970s in Wyoming and Colorado (and, later, in all states) and other unique entity forms and a change in the tax law in 1986, C corporations became less popular. However, 2017 could be the start of renewed interest in the C corporate form. A primary driver of what might cause some to reconsider the use of C corporations is that President Trump campaigned in part on reducing the corporate tax rate. Similarly, in the summer of 2016, the U.S. House Ways and Means Committee released a proposed "blueprint" for tax reform that also contained a lower corporate tax rate. If corporate tax rates are lowered, the use of C corporations may become more prevalent.

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58. *Johnson v. Comm'r,* TC Memo 1985-175 (Apr. 8, 1985).
59. *Waterfall Farms, Inc. v. Comm'r,* TC Memo 2003-327 (Nov. 25, 2003).
60. *Maschmeyer's Nursery, Inc. v. Comm'r,* TC Memo 1996-78 (Feb. 26, 1996)
61. *Dilts v. U.S.*, 845 F. Supp. 1505 (D. Wyo. 1994).
62. IRC §707(a).
63. Treas. Reg. §1.707-1(a).
64. *Armstrong v. Phinney,* 394 F.2d 661 (5th Cir. 1968). See also *Papineau v. Comm'r,* 16 TC 130 (1951), *non-acq.,* 1952-2 CB 5; but see, *Comm'r v. Doak,* 234 F.2d 704 (4th Cir. 1956); *Moran v. Comm'r,* 236 F.2d 595 (8th Cir. 1956); *Comm'r v. Robinson,* 273 F.2d 503 (3d Cir. 1959), *cert. den.,* 363 U.S. 810 (1960).
65. *Wilson v. U.S.,* 376 F.2d 280 (Ct. Cl. 1967).

There are a couple of C corporate "penalty" taxes that practitioners need to consider. These are the accumulated earnings tax and the personal holding company tax.

ACCUMULATED EARNINGS TAX

The accumulated earnings (AE) tax is an addition to a corporation's regular income tax.[66] The AE tax is designed to prevent a corporation from being used to shield its shareholders from the individual income tax through accumulation of earnings and profits. It applies to accumulated taxable income of the corporation (taxable income, with certain adjustments).[67]

Observation. Historically, there has been substantial motivation, even in farm and ranch corporations, not to declare dividends because of their unfavorable tax treatment. Dividends are taxed twice, once when they are earned by the corporation and again when corporate earnings are distributed as dividends to the shareholders. This provides a disincentive for agricultural corporations (and other corporations) to make dividend distributions. Consequently, this leads to a build-up of earnings and profits within the corporation. However, with current favorable 0% or 15% tax rates on qualified dividends, some C corporations may desire to pay dividends to shareholders who are in the lower tax brackets.

The AE tax (at a rate of 20%) applies only to amounts **unreasonably** accumulated during the tax year. Indeed, the computation of "accumulated taxable income" is a function of the reasonable needs of the business. Therefore, the real issue is the extent to which corporate earnings and profits can accumulate before triggering application of the AE tax. To that end, the statute provides for an AE credit which specifies that corporations are permitted to accumulate earnings and profits of $250,000 without imposition of the tax.[68] However, service corporations (those in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting) can only accumulate earnings and profits of $150,000.[69]

Not every corporation that exceeds $250,000 (or $150,000) of accumulated earnings and profits (AEP) is subject to the AE tax. The tax applies only if a particular corporation has accumulated more than $250,000 (or $150,000) in earnings and profits **and** the accumulation is beyond the reasonable needs of the business.

Reasonable Business Needs

For C corporations, it is important that legitimate business reasons for accumulating earnings and profits in excess of $250,000 are sufficiently documented in annual meeting minutes and other corporate records. IRS regulations concede that some accumulations may be proper, and agricultural corporations should try to base their need for accumulating earnings and profits on the IRS guidelines.[70] For instance, an acceptable reason for accumulation could be to expand the business through the purchase of land, the building of a confinement unit, or the acquisition of additional machinery or equipment. Similarly, earnings and profits may be accumulated to retire debt, hire additional people, provide necessary working capital, provide funds to buy out retiring shareholders, or to provide for investments or loans to suppliers or customers in order to keep their business.

66. IRC §531.

67. IRC §§532 and 535.

68. IRC §535(c)(2)(A).

69. IRC §535(c)(2)(B).

70. Treas. Reg. §1.537-2(b).

Improper reasons for excess accumulations trigger application of the AE tax. The IRS specifically targets the following accumulations as being improper.[71]

- Loans to shareholders or expenditures of funds for the benefit of shareholders
- Loans with no reasonable relationship to the business
- Loans to controlled corporations carrying on a different business if the capital stock of such other corporation is owned, directly or indirectly, by the shareholder or shareholders of the taxpayer corporation and such shareholder(s) are in control of both corporations
- Investments unrelated to the business
- Accumulations to provide against unrealistic hazards

It is very important that a corporation's annual meeting minutes document a plan for utilization of AEP. For example, in *Gustafson's Dairy, Inc. v. Comm'r,*[72] the court found that AE tax was not applicable to a fourth-generation dairy operation with one of the largest herds in the United States at one location. The corporation had accumulations of $4.6 million for herd expansion, $1.6 million for pollution control, $8.2 million to purchase equipment and vehicles, $2 million to buy land, $3.3 million to retire a debenture, and $1.1 million to self-insure against loss of herd. The court found those accumulations to be reasonable particularly because the dairy had specific, definite, or feasible plans to use the accumulations, which were documented in corporate records. Those corporate records also showed how the corporation computed its working capital needs. The corporation had a specific plan for the use of corporate earnings and profits, knew its working capital needs, and was not simply trying to avoid tax.

A recent IRS Chief Counsel Advice (CCA) memorandum[73] illustrates the IRS's position on a taxpayer's potential exposure to the AE tax. The IRS took the position that the AE tax can apply even though a corporation is illiquid.[74] The AE tax does not depend on the amount of cash available for distribution. It is based on accumulated taxable income and not on the corporation's liquid assets. The IRS noted that IRC §565 contains consent dividend procedures that an illiquid corporation can use to allow the payment of a deemed dividend. Both the AE tax and the personal holding company (PHC) tax (discussed next) are penalty taxes that are strictly construed.

PERSONAL HOLDING COMPANY TAX

The PHC tax is imposed on C corporations when the corporation is, in essence, used as a personal investor by not distributing PHC income. The PHC tax of 20% for tax years after 2012 is levied on undistributed PHC income (taxable income less dividends actually paid, federal taxes paid, excess charitable contributions, and net capital gains).[75]

To be a PHC, two tests must be met. The first test is an **ownership test** and is satisfied if five or fewer people own more than 50% of the corporate stock during the last half of the tax year.[76] Most farming and ranching operations meet this test. The second test is an **income test** and is satisfied if 60% or more of the corporation's **adjusted ordinary gross income** (reduced by production costs) comes from passive investment sources.[77]

71. Treas. Reg. §1.537-2(c).
72. *Gustafson's Dairy, Inc. v. Comm'r,* TC Memo 1997-519 (Nov. 17, 1997).
73. CCA 201653017 (Sep. 8, 2016).
74. Ibid.
75. IRC §§541–547.
76. IRC §542(a).
77. Ibid.

The Potential Problem of Rental Income

Rental income is included in adjusted ordinary gross income **unless** adjusted rental income[78] is at least 50% of adjusted ordinary gross income, and dividends for the tax year equal or exceed the amount (if any) by which the corporation's nonrent PHC income for that year exceeds 10% of its ordinary gross income.[79] Thus, farming and ranching corporations engaged predominantly in rental activity may not be subject to the PHC tax. However, if the corporation's nonrent PHC income (dividends, interests, royalties, and annuities) is substantial, the corporation must make taxable dividend distributions to avoid imposition of the PHC tax. **Therefore, corporations that own agricultural land that is cash rented and whose only passive income source is cash rent are not subject to the PHC tax.**

Example 1. Farmco is a solely-owned corporation with adjusted ordinary gross income of $100,000, of which $49,990 is adjusted income from cash rent of farmland (gross rents of $200,000 – adjustments of $150,010). The $49,990 is PHC income because it is less than 50% of adjusted ordinary gross income ($100,000).

Example 2. Ranchco is a solely-owned corporation with ordinary gross income of $300,000 and adjusted ordinary gross income of $100,000, of which $51,000 is adjusted income from rents ($200,000 gross rents – adjustments of $149,000) and $31,000 in dividend income. The adjusted income from rents of $51,000 is PHC income, because, although it exceeds 50% of adjusted ordinary gross income ($100,000 × 50% = $50,000), other PHC income (dividends of $31,000) exceeds 10% of ordinary gross income ($300,000 × 10% = $30,000). In addition, total PHC income ($51,000 + $31,000) exceeds 60% of adjusted ordinary gross income ($100,000 × 60% = $60,000). Therefore, the PHC tax applies.

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Observation. For many farm and ranch corporations, the potential for being a PHC is a serious problem. A common scenario is for a farmer or rancher to retire with a tenant or child continuing to farm or ranch the land and pay rent. The receipt of rents could cause the corporation to be a PHC.

Having the proper type of lease is critical to avoid imposition of the PHC tax. For example, in *Webster Corporation v. Comm'r,*[80] the IRS argued that a farm corporation became a PHC. The IRS lost the case because the lease was a material participation crop share lease and substantial services were provided by a farm manager. The farm manager's activities were imputed to the corporation as land owner. The court held that income under such a lease was business income and not rental income. However, if the lease is not a material participation crop share lease, then the landlord receives rent. Certainly, fixed cash rents will be treated as rent. If the corporation receives only rental income, the rents are not PHC income. However, if the corporation also receives other forms of investment income, the rents can be converted into PHC income.

In the typical farm or ranch corporation setting, there is usually a mixture of rental income and other passive income sources. Over time, the corporation typically builds up a balance in the corporate treasury from the rental income and then invests that money, which produces income from other passive sources. As a result, there is, eventually, a mixture of rental income and other passive income sources that triggers application of the PHC tax. For farming and ranching operations structured as multiple entities, this is one of the major reasons that the landholding entity should not be a C corporation. The only income that a landholding C corporation initially has is rental income. However, the tendency to invest the rental income over time will most likely trigger application of the PHC tax in subsequent years.

Note. A limiting factor to both the AE tax and the PHC tax is taxable income. If the corporation has no taxable income, it is not accumulating earnings and is not subject to the AE tax. Additionally, corporations without taxable income are usually not subject to the PHC tax. Form 1120, Schedule PH, *U.S. Personal Holding Company (PHC) Tax,* can be used to determine if the corporation is subject to the PHC tax.

78. See IRC §543(b)(3).

79. IRC §543(a)(2).

80. *Webster Corporation v. Comm'r,* 25 TC 55 (1955).

CASH METHOD OF ACCOUNTING FOR FARMERS

The IRS has a long history of challenging taxpayers that it believes are distorting income by using the cash method of accounting. Three recent cases serve as examples of the continued IRS challenges of farmers using the cash method of accounting.

- In *Burnett Ranches, Limited v. U.S.,*[81] a federal appeals court, in a case involving a Texas cattle and horse breeding limited partnership, sternly disagreed with the IRS challenge of that operation's use of cash accounting via the "farming syndicate rule." Despite the rebuke, the IRS subsequently issued a nonacquiescence to the court's decision, signaling that their challenge of the cash method will continue.
- In *Agro-Jal Farming Enterprises, Inc., et al. v. Comm'r,*[82] the IRS tried to deny a deduction for a California farming corporation that deducted the cost of field packing materials until the year the materials were actually consumed. The IRS lost the case based on its own regulation.
- In *Estate of Backemeyer v. Comm'r,*[83] the IRS tried to deny a farmer's surviving spouse a deduction for the cost of inputs she used to plant the crop that he had purchased before his death. He died before he could use them to plant the spring crop. Although the farmer had deducted the costs of the inputs as prepaid expenses in the year before he died, the IRS claimed she could not deduct the same amount the following year on her return even though the value of the inputs was included in his estate under IRC §1014.

FARMING SYNDICATE RULE

In both the *Burnett Ranches, Limited* and *Agro-Jal Farming* cases, the IRS attempted to utilize the **farming syndicate rule** to bar the deductions that the IRS deemed to be distorting income. For farm and ranch taxpayers, the alleged distortion often arises in the context of prepayment for inputs such as fertilizer, seed, feed, or chemicals. Various tests and rules have been adopted over the years to deal with material distortions of income when prepaid purchases are involved.[84] One of those rules, which is designed to place a limitation on deductions for farming operations, was developed in the 1970s and is known as the farming syndicate rule.[85] The rule prohibits "farming syndicates" from taking deductions for feed, seed, fertilizer, and other farm supplies before the year in which the supplies are actually used or consumed. Under the rule, a farming syndicate is one of the following.[86]

1. A partnership or other enterprise (other than a corporation that is not an S corporation) engaged in farming if the ownership interests in the firm have been offered for sale in any offering required to be registered with any federal or state securities agency
2. A partnership or other enterprise (other than a corporation that is not an S corporation) engaged in farming if more than 35% of the losses during any period are allocable to limited partners or limited entrepreneurs (35% test)

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81. *Burnett Ranches, Limited v. U.S.,* 753 F.3d 143 (5th Cir. 2014), *nonacq.,* 2017-7 IRB 868; AOD 2017-01 (Feb. 28, 2017).
82. *Agro-Jal Farming Enterprises, Inc., et al. v. Comm'r,* 145 TC No. 5 (Jul. 30, 2015).
83. *Estate of Backemeyer v. Comm'r,* 147 TC No. 17 (Dec. 8, 2016).
84. *See, e.g.,* Rev. Rul. 79-229, 1979-2 CB 210.
85. IRC §461(j).
86. IRC §461(j)(1).

Active Participation Exception

If an individual has actively participated (for a period of not less than five years) in the management of the farming activity, any interest in a partnership or other enterprise that is attributable to that active participation is deemed to **not** be held by a limited partner or a limited entrepreneur. Thus, the interest does not count toward the 35% test for a farming syndicate.[87] However, in the IRS's view, the exception for active management only applies to an "individual."

In CCA 200840042,[88] the IRS determined that a partnership interest held by an S corporation with only one shareholder was to be treated as held by a limited partner for purposes of the farming syndicate rule. The partnership raised and bred livestock, and its three members were two trusts and the S corporation. The S corporation was owned by a trustee who was also a beneficiary of the trusts. One of the trusts was the general partner of the partnership. The partnership reported income on the cash method, but the IRS took the position that the partnership interest that the S corporation held had to be treated as a limited partner interest because it was not held by an "individual."

Observation. The IRS took this position even though the S corporation's sole shareholder was an individual. Thus, for purposes of the farming syndicate rule, the interest held by the S corporation was treated as an interest that was held by a limited partner.

Burnett Ranches[89] involved a Texas cattle and horse breeding limited partnership that was 85.52% owned by an S corporation as a limited partner. As such, the limited partnership met the definition of a farming syndicate. However, the court held that the ranch qualified for the active participation exception to the farming syndicate rule even though the majority owner actively participated in managing the cattle operation through the owner's wholly-owned S corporation. The court noted that the west Texas operation had been family-run for many generations dating back to the 1800s, with the current majority-owner family member simply owning her interest via an S corporation. There was no question that the majority owner managed the operation and would satisfy the active management test in her own right. The IRS acknowledged as much.

The IRS said the farming syndicate rule was triggered and cash accounting was not available because the ownership interest was held in an S corporation rather than directly by the majority shareholder as an individual. Consequently, the IRS said that the partnership could not use cash accounting for the years in issue (2005 through 2007). The limited partnership paid the alleged deficiencies (which amounted to several million dollars) and sued for a refund in federal district court. The sole basis for the IRS denial of the cash method under the farming syndicate rule (and the required switch to the accrual method) was the fact that the S corporation owned the partnership interest, even though it was an S corporation that was 100% owned by the person that performed the entire management function of the business. The district court ruled for the limited partnership.

87. IRC §461(j)(2)(A).

88. CCA 200840042 (Jun. 16, 2008).

89. *Burnett Ranches, Ltd. v. U.S.,* 753 F.3d 143 (5th Cir. 2014).

The IRS appealed, continuing to maintain that the majority owner's interest in the limited partnership via her S corporation barred the application of the active management exception. The apellate court disagreed, largely on policy grounds. The apellate court noted that the congressional intent behind the active management exception of IRC §464(c)(2)(A) was to target high-income, non-farm investors, not the type of taxpayer that the majority owner represented. The court also noted that the statutory term "interest" was not synonymous with legal title or direct ownership, but rather was tied to involvement with or participation in the underlying business. Thus, the apellate court determined that there was no basis for distinguishing between "the partnership interest of a rancher who has structured his business as a sole proprietorship and a rancher who has structured his business as [a subchapter S] corporation." The term "individual" was used in the statute to refer to the provision of active management rather than referring to an interest in the activity at issue.

Note. The apellate court's opinion is binding authority inside the Fifth Circuit (Louisiana, Mississippi, and Texas). However, in AOD 2017-01,[90] the IRS signaled that it will challenge the same issue elsewhere.

PREPAID EXPENSES

In *Agro-Jal,*[91] the plaintiff raised strawberries and vegetables. It used field-packing materials such as plastic clamshell containers and cardboard trays and cartons in its in-field packing process. It purchased these materials in bulk, in advance of the harvest. The supplies not used by yearend were reflected as expenses in its accrual basis financial statements in the year consumed, rather than when paid. Agro-Jal reported its income for tax purposes on the cash basis but prepared financial statements using generally accepted accounting principles (GAAP) for financing purposes. Agro-Jal also kept detailed records of the field packaging materials on hand at the end of the year, which it capitalized on its yearend financial statements.

The Tax Court was faced with the issue of whether the plaintiff could deduct the packaging materials in the year the materials were paid for or whether it could only deduct the amounts as the materials were used. The IRS conceded that cash method farmers may deduct farm supplies immediately upon purchase but argued that the farming syndicate rules limited an immediate deduction for expenses attributable to "feed, seed, fertilizer, or other similar farm supplies." It asserted that Agro-Jal's field packing materials were not "other similar farm supplies" for this purpose. The IRS cited the 50% rule of IRC §464, under which immediate deductions are allowed only for "feed, seed, fertilizer, or other similar farm supplies" when the prepaid amounts for those expenses do not exceed 50% of all farming expenses during any 3-year period. However, if the field packing materials were farm supplies under this provision, the 50% limit would not be exceeded and their cost would be fully deductible. In essence, the IRS argued that only feed, seed, fertilizer, or other similar farm supplies may be deducted immediately upon purchase but that all other supplies could only be deducted as consumed.

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

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

90. AOD 2017-01 (Feb. 13, 2017).

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

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

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

Reporting the amount as a deferred expense on its balance sheet required Agro-Jal to take a physical inventory, which meant that the supplies were nonincidental. That is a distinction made by the tangible property regulations for tax years beginning after 2013.[92] However, because the years at issue predated the effective date of the revisions made by the tangible property regulations, the Tax Court did not address the distinction between incidental and nonincidental materials and supplies.

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

> **Note.** Farmers are specifically allowed to deduct amounts actually expended that are attributable to items used in conducting their farming business. This general principle is only limited if other specific Code provisions provide otherwise (e.g., IRC §263A for the uniform capitalization rules, IRC §464 for the 50% rule, IRC §175 for soil and water conservation expenditures, etc.). In addition, **Treas. Reg. §1.162-12(a) was not affected in any manner by the tangible property regulations,** and it remains the authority for farmers to deduct "all amounts actually expended in carrying on the business of farming."

The IRS again challenged the tax treatment of prepaid expenses in *Estate of Backemeyer v. Comm'r.*[93] This case involved a sole proprietorship farming operation in Nebraska. The sole-proprietor farmer purchased crop inputs (herbicides, seeds, fertilizer and lime, fuel, etc.) worth $235,693 in the fall of 2010 that he planned to use in connection with planting the spring 2011 crops. However, he died on March 13, 2011, before using any of the inputs. The inputs were listed in his estate's inventory, with their value set at their purchase price. Shortly before he died, he sold his 2010 crop in January 2011, and that income was reported on line 3b (taxable amount of cooperative distributions) of his 2011 Schedule F. His estate did not include any interest in stored grain. The farm inputs passed to a family trust that named his surviving wife as the trustee.

The wife ran the farming operation after her husband's death and took an in-kind distribution of the farm inputs from the trust, which she used to grow corn and soybeans in 2011. She sold a portion of the crops grown in 2011 later that fall and reported those sale proceeds ($301,100) on line 3b of her 2011 Schedule F. She sold the balance of the 2011 crops in 2012, a year for which she filed as a single taxpayer.

92. TD 9636, 2013-43 IRB 331.

93. *Estate of Backemeyer v. Comm'r,* 147 TC No. 17 (Dec. 8, 2016).

The couple filed a joint return for 2010, on which they claimed $235,693 of prepaid expenses. The joint 2011 return included two Schedules F. The wife's Schedule F claimed expenses of the exact amount that had been claimed as prepaid expenses on the husband's 2010 Schedule F. The IRS rejected the deduction on the wife's 2011 Schedule F, thereby increasing taxable income by $235,693 and resulting in a tax deficiency of $78,387. The IRS denied the deduction because "the petitioners use the cash method for [their] farming activity, prepaid expenses that were paid in 2010 are deductible in 2010, and are not added to basis." According to the IRS, the taxpayers were getting a double deduction, which they were not entitled to. The IRS reasoned that if the court were to allow the deduction on the wife's 2011 Schedule F, then that same amount should be included as income in the husband's 2011 Schedule F. If this did not happen, the IRS claimed that a material distortion of income would result. The IRS also claimed that the surviving wife was not entitled to a step-up in basis under IRC §1014 in the inherited farm inputs. The IRS tacked on an accuracy-related penalty of $15,864 under IRC §6662(a).

The IRS changed course and argued that the tax benefit rule controlled the outcome of the case. The IRS conceded that the surviving spouse properly deducted the inputs on her 2011 return because she received the inputs with a stepped-up basis and proceeded to use them in her farming business. However, the IRS claimed the tax benefit rule required the inclusion in the husband's 2011 return of the amount of the prepaid input expense that had previously been deducted for 2010.

The IRS cited *Bliss Dairy, Inc. v. Comm'r*[94] for its claimed application of the tax benefit rule. In that case, a cash method corporate dairy deducted the purchase cost of cattle feed. Early the next year, the corporation liquidated while there was a significant amount of feed remaining on hand. The corporation distributed its assets to its shareholders in a nontaxable transaction. The shareholders continued to operate the dairy and deducted their basis in the feed as an expense of doing business. The U.S. Supreme Court said that the tax benefit rule applied because the liquidation of the corporation changed the cattle feed to being used for a nonbusiness purpose that was now inconsistent with the earlier deduction. The IRS claimed that the facts of *Backemeyer* were the same and should produce the same result.

The IRS claimed that because Mr. Backemeyer died before using the inputs in his farming business, the inputs were converted to a nonbusiness use at the time they were transferred to the trust. Upon distribution to the wife for use in her farming business, the inputs were converted back to business use, which entitled her to deduct their cost. The IRS asserted that this also required the husband's return to recognize income because he converted the inputs from one use to another by dying unexpectedly at the wrong time.

The Tax Court rejected the IRS's argument. In *Frederick v. Comm'r,*[95] the Tax Court laid out a 4-factor test for application of the tax benefit rule.

1. A deduction was taken in the prior year.
2. The deduction resulted in a tax benefit.
3. An event occurred in the current year that is inconsistent with the premises on which the deduction was originally based.
4. A nonrecognition provision of the Code does not prevent inclusion in gross income.

In *Backemeyer*, the first two factors were satisfied, but the Tax Court determined that factors 3 and 4 were not. Regarding factor 3, the court noted that neither the husband's death nor the distribution of the inputs to his wife for use in her farming business were inconsistent with the deduction on his 2010 return. The Tax Court noted that if the wife had inherited the inputs in 2010 and used them in 2010, the initial deduction would not have been recaptured for income tax purposes because of the estate tax. The inputs were subject to the estate tax on their purchase price, which was the same basis used for the income tax deduction. Thus, application of the tax benefit rule would result in double taxation of the inputs' value.

94. *Bliss Dairy, Inc. v. Comm'r,* 460 U.S. 370 (Mar. 7, 1983).

95. *Frederick v. Comm'r,* 101 TC No. 35 (Jul. 21, 1993).

Factor 4 was also not satisfied. Upon the husband's death, the basis step-up rule applied. In addition, the gross income of the recipient of an asset does not include the value of the inherited assets. Upon disposition of the assets by the heir, the heir has taxable gain only to the extent the proceeds exceed the stepped-up basis. Moreover, depreciation recapture is not triggered upon death under either IRC §§1245 or 1250. Those rules are a partial codification of the tax benefit rule and do not apply at death.

Thus, the tax benefit rule did not apply and did not require the inclusion in the husband's 2011 Schedule F of the amount that had been deducted for the prepaid inputs that were claimed on the 2010 Schedule F. In addition, the court removed the accuracy-related penalty.

Observation. The tax benefit rule is inapplicable when crop inputs are deducted in an earlier year and then again in a later year by a surviving spouse who inherits the inputs as the result of a spouse's death and uses them in the surviving spouse's farming business.[96]

INDIRECT COSTS OF PRODUCTION

Before the Tax Reform Act of 1986, taxpayers had the option of either capitalizing or deducting expenses incurred during a business asset's preproductive period. However, for tax years beginning after 1986, taxpayers must capitalize the direct costs of production and the "proper share" of indirect costs that are assignable to the production of property that the taxpayer uses in their trade or business.[97] This uniform capitalization rule prevents the current deduction of these costs during the preproductive period.

APPLICATION TO ANIMALS

The 1986 rule change applied to both animals and plants.[98] As applied to animals, if the preproductive period was more than two years, a taxpayer could not deduct expenses associated with the preproductive period of replacement heifers for a cow/calf or dairy herd, for example. Instead, the taxpayer had to keep track of costs and capitalize them.

In 1988, Congress repealed the capitalization rule for animals produced by the taxpayer in a farming business for costs incurred after 1988. The repeal provisions refer to **animals** and not livestock. However, beginning January 1989, **farm** property of a **taxpayer engaged in a farming business** cannot be depreciated at a rate that exceeds the 150% declining-balance method.[99]

APPLICATION TO PLANTS

The uniform capitalization rules are still in effect for plants used in a farming business. Consequently, taxpayers who have a crop with more than a 2-year preproductive period are not permitted to deduct the costs associated with that crop during the preproductive period.[100]

Note. There are some nuances to the application of the rule, but it primarily impacts taxpayers who are in the nursery business and almost all tree, vine, or bush crops that require at least two years to reach production.

96. See *Estate of Backemeyer v. Comm'r,* 147 TC No. 17 (Dec. 8, 2016) and IRC §1014.

97. IRC §263A.

98. IRC §263A(d)(1)(A).

99. Committee Reports on PL 100-647 (Technical and Miscellaneous Revenue Act of 1988).

100. Ibid.

The IRS has said that a nursery could deduct the cost of purchasing "bare root" trees as an ordinary and necessary business expense when the trees were all very young.[101] Under the facts of the IRS Advice, many trees did not survive and all trees required years of development and cultivation to ensure future marketability. In essence, the trees qualified as "seeds and young plants" under Treas. Reg. §1.162-12. Thus, when some maturation of the trees is contemplated, nursery operators do not need to capitalize associated costs if the preproductive period is two years or less.[102] Also, the IRS stated that costs incurred between the harvest of a grape crop and the end of the preproductive period must be capitalized unless they are "field costs" (i.e., irrigation, fertilization, spraying, and pruning) that provide no benefit to the already severed crop.[103]

Preproductive Period

The preproductive period begins when a seed is planted or a plant is first acquired by the taxpayer. It ends when a plant is ready to be produced in marketable quantities or when a plant can reasonably be expected to be sold or otherwise disposed of[104] (i.e., from the time of planting to the time of first harvest). The preproductive period, however, is determined not in light of the taxpayer's personal experience but in light of the weighted average preproductive period determined on a nationwide basis.[105] In other words, a taxpayer cannot use their own experience to determine whether a plant or crop has a preproductive period of two years or less.[106] In addition, the uniform capitalization rule applies even if a taxpayer acquires land with a growing crop in the midst of the crop's preproductive period and there is less than two years left until the crop becomes marketable.

Note. The IRS has provided a list of plants grown in commercial quantities in the United States that have a nationwide weighted average preproductive period in excess of two years.[107] Included on the list are almonds, apples, apricots, avocados, blueberries, cherries, chestnuts, coffee beans, currants, dates, figs, grapefruit, grapes, guavas, kiwifruit, kumquats, lemons, limes, macadamia nuts, mangoes, nectarines, olives, oranges, peaches, pears, pecans, persimmons, pistachio nuts, plums, pomegranates, prunes, tangelos, tangerines, tangors, and walnuts.[108]

Interest and Property Taxes

Under the uniform capitalization rules, certain costs of production must be capitalized. IRC §263A(f)(1) specifies that interest is capitalized when:

1. The interest is paid during the production period; and
2. The interest is allocable to real property that the taxpayer produced and that has a long useful life, an estimated production period exceeding two years, or an estimated production period exceeding one year and a cost exceeding $1 million.

Treas. Reg. §1.263A-8 states that "Capitalization of interest under the avoided cost method described in Treas. Reg. §1.263A-9 is required with respect to the production of designated property…" The rules also require the capitalization of real property taxes incurred during the production period, as noted in the case discussed next.

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101. TAM 9818006 (Jan. 6, 1998).
102. IRS Ann. 97-120, 1997-50 IRB 61.
103. CCA 200713023 (Nov. 20, 2006).
104. Treas. Reg. §1.263A-4(b)(2)(C).
105. Treas. Reg. §1.263A-4(b)(2)(B).
106. See, e.g., *Pelaez and Sons, Inc. v. Comm'r,* 114 TC No. 473 (11th Cir. 2001), *aff'g,* 114 TC No. 28 (2000).
107. IRS Notice 2000-45, 2000-2 CB 256.
108. Blackberries, raspberries, and papayas used to be on the list, but the IRS removed them in 2013. Rev. Proc. 2013-20, 2013-14 IRB 744.

Wasco Case. In *Wasco Real Properties I, LLC, et al. v. Comm'r,*[109] three partnerships bought land that they planned to use for growing almonds. They financed the purchase by borrowing money and paying interest on the debt. They deducted the interest and property taxes on their return. The IRS objected on the basis that the interest and real property taxes were indirect costs of the production of real property (i.e., the almond trees that were growing).

In determining whether the uniform capitalization rules applied to interest and real property taxes, the court noted that IRC §§263A(b)(1) and (c)(1) apply to real property produced by the taxpayer for the taxpayer's use in a trade or business or in an activity conducted for profit. The court further noted that the definition of "real property" includes "land" and "unsevered natural products of land." "Unsevered natural products of land" generally include "[g]rowing crops and plants where the preproductive period of the crop or plant exceeds two years."[110] While almond trees are on the IRS list as having a preproductive period of more than two years, the taxpayer claimed they could currently deduct the interest and property taxes because those costs related to the land and not the almond trees. The taxpayer claimed it was in the business of producing almonds, not land. The court disagreed. Although the court agreed that the taxpayer was in the business of growing almonds, the trees grew on the land. As such, land itself need not be produced because the almond trees are intertwined with the land and cannot grow without it. Thus, the placing in service of the almond trees required that the land be placed in service, and the interest and tax cost of the land was a necessary and indispensable part of the growing of the almond trees. The unit of property was the land **and** the almond trees. Thus, the property taxes and interest associated with the portion of the land benefiting the almond trees had to be capitalized.

The Tax Court, in *Wasco,* said that the taxpayer had to change its method of accounting for the interest and property tax cost and adjust the amounts deducted in prior years that should have been capitalized. Such a method change will trigger an IRC §481(a) adjustment, which the taxpayer must report on Form 3115, *Application for Change in Accounting Method.*

Observation. While an accounting method cannot be changed more frequently than once every five years, Form 3115 does not cover blanket accounting method changes. It applies to a particular trade or business activity. This means that if, for example, a Form 3115 had been filed (even if unnecessarily) within the immediately preceding five years for purposes of the recently implemented repair/capitalization regulations, another Form 3115 can be filed for purposes of the uniform capitalization rules.

Avoiding the Rule. An election can be made to avoid capitalization of preproductive costs. However, if the election is made, all farm assets must be depreciated using the alternative depreciation system.[111] That requires straight-line depreciation over the **class life** of the property for **all farm assets** of the taxpayer that are used in the farming business. There is, however, a limitation on the use of the election that applies to citrus and almond growers.[112] In addition, the election (made via Form 3115) must be made for the first year in which costs subject to the capitalization rules apply.[113]

Observation. The election might be beneficial for taxpayers just starting out in farming who do not have a lot of income to offset with farm deductions or those who do not have many depreciable assets. Conversely, agricultural producers that do not raise many crops with a preproductive period that exceeds two years probably should not make the election. By not making the election, they preserve their ability to use MACRS depreciation on farm assets (as well as first-year "bonus" depreciation).

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109. *Wasco Real Properties I, LLC, et al. v. Comm'r,* TC Memo 2016-224 (Dec. 13, 2016).

110. Treas. Reg. §1.263A-8(c)(2).

111. IRC §§263A(d)(3) and (e)(2).

112. IRC §263A(d)(3)(C).

113. IRC §263A(d)(3)(D).

> **Note.** Another way to avoid the impact of the uniform capitalization rules is to make an IRC §179 election.[114] In addition, starting in 2016, a taxpayer can elect bonus depreciation for fruit/nut plants at the time of planting or grafting rather than waiting until the plants become productive.[115]

DEPRECIATION STRATEGIES IN AGRICULTURE

PURCHASED LIVESTOCK

Purchased livestock that is held primarily for sale must be included in inventory (along with all items that are held for sale or for use as feed, seed, etc., that remain unsold at the end of the year). Livestock that is acquired for draft, breeding, or dairy purposes may be depreciated by a farmer using either the cash or accrual method of accounting, unless the livestock is included in inventory.[116] Cash basis farmers and ranchers are allowed to currently deduct all costs of raising livestock; therefore, only purchased livestock are required to be capitalized and held in inventory or depreciated.[117]

The decision to depreciate livestock (including fur-bearing livestock) or include them in inventory can be an important one for many farmers and ranchers.

IRC §1231 Assets

IRC §1231 assets are depreciable business property that has been held for more than one year. Such assets include buildings and equipment, timber, natural resources, unharvested crops, livestock, and other types of business assets. One benefit of §1231 is that gains and losses on §1231 property are netted against each other in the same manner as capital gains and losses, except that a net §1231 gain is capital in nature (e.g., taxed at a preferential rate), but a net §1231 loss is treated as an ordinary loss.

IRC §1231(b)(3) requires that cattle and horses held for draft, breeding, dairy, or sporting purposes must be held for at least 24 months to qualify for §1231 status. Other livestock is only required to be held at least 12 months. IRC §1231 property does not include, for example, inventory and property held for sale in the ordinary course of business.

IRC §1231 tax treatment is **not** available if the taxpayer includes livestock in inventory. However, a farmer might have animals listed in the closing inventory in a year that are then transferred to the depreciation schedule in the next year when the animals reach maturity and become productive. In that event, the inventory value of the animals in the first year's closing inventory should be subtracted from the beginning inventory for the subsequent year.

Even some livestock that is not §1231 property is depreciable. For example, poultry held for more than one year for breeding or egg-laying purposes may be depreciated if not held primarily for resale.[118]

Livestock held for sporting purposes is not specified as depreciable.[119] However, sporting assets may be depreciated as business assets.

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114. Treas. Reg. §1.263A-4(d)(4)(ii).
115. IRC §168(k)(5).
116. Treas. Reg. §1.167(a)-6(b).
117. Treas. Reg. §1.162-12.
118. Treas. Regs. §§1.167(a)-3 and 1.167(a)-6(b); *Garth v. Comm'r,* 56 TC 610 (1971).
119. See Treas. Reg. §1.167(a)-6(b).

Sheep and furbearing animals have been held to be §1231 assets.[120] This implies that the animals are depreciable. One case, however, has disallowed depreciation deductions for sheep held for breeding, wool, and resale purposes.[121]

> **Observation.** Any livestock held for sale that is not breeding, draft, dairy, or sporting livestock is subject to ordinary income tax rates, regardless of the holding period. Only livestock held for breeding, draft, dairy, or sporting purposes qualifies for long-term capital gain rates under §1231.

Depreciate or Include in Inventory

The key question for a farmer/rancher is whether breeding livestock that are not held primarily for resale should be depreciated or included in inventory. The depreciation of livestock is beneficial to the producer for many reasons.

- Depreciation is an ordinary deduction and reduces the farmer's net income and SE income.
- Although the depreciation taken on the livestock must be recaptured under IRC §1245, this recapture is not subject to SE tax for Schedule F purposes or for farmers operating as a partnership.
- The amount of gain in excess of original cost, if held for the applicable period, is taxed at favorable capital gains rates under §1231.

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Example 3. Farmer Jones purchased a cow for breeding purposes and paid $2,000 on January 1, 2014. Over the next three years, Farmer Jones took $1,160 of depreciation on the cow and reduced his farm income and SE income by this amount. He sold the cow for $3,000 on January 1, 2017. At that time, Farmer Jones must recapture the $1,160 of depreciation originally taken on the cow at ordinary income tax rates (however, it is not subject to SE tax). The $1,000 gain in excess of the original cost of $2,000 is subject to long-term capital gains rates because he held the cow for more than two years.

The question of whether the result illustrated by the example is preferable to holding the cow in inventory depends on whether a current deduction for depreciation outweighs subsequent capital gain treatment upon sale. Additionally, the eventual capital gain treatment is limited by depreciation recapture, which means that ordinary income rates apply to the portion of the gain on the sale attributable to the amount of depreciation previously claimed.

Accrual Basis Taxpayers

In general, if an accrual basis farm taxpayer wants to achieve a lower tax rate on future gains from the qualified sale of breeding, draft, dairy, or sporting livestock, livestock should generally be inventoried at the highest possible value. In this situation, care should be taken in selecting which inventory method to use.

Because any particular animal's inventory value determines its basis for the computation of gain or loss on sale, the inventory method impacts the ordinary gain on sale. Thus, any method that assigns a relatively low value to an animal results in a relatively greater ordinary gain upon the animal's sale.

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120. See Treas. Reg. §1.1231-2(a)(3).

121. *Belknap v. U.S.,* 55 F.Supp. 90 (W.D. Ky. 1944).

The following are the available inventory methods.[122] The method used by a farmer or rancher must conform to generally accepted accounting principles and must clearly reflect income.

- **Cost method.** This method values inventory at its cost, including all direct and indirect costs.
- **Lower-of-cost-or-market method.** This method compares the market value of each animal on hand at the inventory date with its cost and uses the lower of the two values as the inventory value for that animal.
- **Farm-price method**. This inventory method values inventories at market price less the direct cost of disposition. Generally, this method must be applied to all property that the taxpayer produces in the taxpayer's trade or business of farming **except** for any livestock that are accounted for by electing the unit-livestock-price method of accounting.
- **Unit-livestock-price method.** Livestock is classified into groups based on age and kind. Then, the livestock in each group (class) is valued by using a standard unit price for each animal in that class. Essentially, a taxpayer divides the livestock into reasonable classifications based on age and kind, with the unit prices for each class accounting for the normal costs of producing and raising those animals. If purchased livestock are not mature, the cost of the livestock must be increased at the end of each year in accordance with the established unit prices, except for animals acquired during the last six months of the year. This can result in a situation in which the taxpayer receives a current deduction attributable to the costs of raising the livestock without any additional unit increase in the animal's closing inventory value.

When an animal is included in inventory at its unit price at maturity, its inventory value cannot be written down later to reflect a decline in its value because of, for example, a loss in value due to aging irrespective of whether the animal has not yet reached marketable age.

When advising clients about whether to depreciate or inventory animals, practitioners should keep the following points in mind.

1. For taxpayers who anticipate generating significant income from the sale of draft, dairy, or breeding livestock and who inventory livestock, an inventory method (such as the lower-of-cost-or-market method and the unit-livestock-price method) that maximizes capital gain on sale rather than income in the years preceding the sale will likely be beneficial.
2. Consideration should be given to the principle that inventorying livestock usually causes a reduction in current deductions against ordinary income.
3. When depreciated livestock is sold, depreciation deductions previously taken are recaptured as ordinary income. However, this income is not subject to SE tax and the amount of gain in excess of original cost is subject to favorable long-term capital gains treatment.

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

HOOP STRUCTURES

A "hoop structure" is a shelter that can house livestock (swine, cattle, sheep, goats, and horses), but it can also be used to store agricultural commodities or machinery. If used for storage, it is an alternative to the more traditional pole barn.

A hoop structure is built with steel arches that are mounted on wood or concrete sidewalls. The steel arches are securely fastened to the sidewall to transmit the wind forces to the sidewalls and the ground. If the structure is used for livestock, then a feed bunk is placed outside the sidewall. Putting the feed bunk outside the sidewall eliminates the need for an interior drive path. An overhang is added to reduce the rainwater entering the bunk. A polyethylene fabric tarp stretches over the steel framing to form the roof of the structure, and the tarp is designed to reflect solar radiation to prevent heat stress. Lighting is not always used. The structure may be either installed directly on the ground or on concrete or wooden walls.

Depreciation Recovery Period

A hoop structure is farm real property. Under Rev. Proc. 87-56, farm real property can be classified at least four ways.

1. A land improvement (class 00.3) has a cost recovery period of 15 years.
2. A single-purpose agricultural or horticultural structure (class 01.4) has a cost recovery period of 10 years.[123]
3. IRC §1245 real property with no class life has a cost recovery period of seven years.
4. A farm building (class 01.3) has a cost recovery period of 20 years.

Land Improvement. A land improvement is an item that is added directly to land. If the improvement is depreciable, it is either §1245 or §1250 property. Fences, landscaping, roads, sidewalks, canals, and waterways fit in this category.[124] Also included in this category are silage bunkers, concrete ditches, wasteways, and pond outlets, as well as irrigation and livestock watering wells. None of these look like buildings. Thus, a hoop structure would not fit in this category.

Single-Purpose Agricultural or Horticultural Structure. IRC §48(p), even though it has been repealed, contains the current, valid definition of a single-purpose agricultural or horticultural structure.

That provision (and subsections thereunder) defined property that qualified for the IRC §38 investment tax credit. Tax legislation in 1986 moved that language into IRC §1245 for depreciation recapture purposes. Under that definition, a single-purpose agricultural structure is used for housing, raising, and feeding a **particular type** of livestock and their produce and the housing of the necessary equipment.[125] Structures that fit this definition include hog houses, poultry barns, livestock sheds, milking parlors, and similar structures. Also included within the definition are greenhouses that are constructed and designed for the commercial production of plants and a structure specifically designed and used for the production of mushrooms. Thus, only livestock structures and greenhouses qualify under this category. A hoop structure is not a single-purpose structure and does not fit in this category. It can house various types of livestock and store commodities and/or machinery.

> **Observation.** A flat storage building has been held not to be a single-purpose agricultural or horticultural structure.[126] A flat storage building is analogous to a hoop structure.

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

124. Rev. Proc. 87-56, 1987-2 CB 674.

125. Treas. Reg. §1.48-10.

126. *Bundy v. U.S.,* CV85-L-575 (D. Neb. 1986).

IRC §1245 Property. Assets that look like a building but qualify as §1245 assets (and are not separately classified as single-purpose agricultural or horticultural structures) are not "buildings."[127] These assets are essentially machinery and equipment that are an integral part of manufacturing or production.[128] This category includes storage facilities for potatoes, onions, and other cold storage facilities for fruits and vegetables. If the asset is used for other purposes after the commodities have been removed, the structures are buildings, rather than §1245 property.[129] Thus, if the property is **easily adaptable** to other uses, it is a building and not IRC§1245 real property. However, if the property is specially designed and unsuitable for other uses, it is not a building.[130] The question of what "easily adaptable" means is determined on a case-by-case basis, depending on the cost of the structure in each situation. Whether a hoop structure fits in this category depends on the particular situation.

> **Note.** If a structure is specifically designed to provide for the stress and other demands of the property it houses and cannot be economically used for other purposes, the structure is likely not a building.[131]

General Purpose Farm Building. A farm building, by default, is a real property item that is not included in another class. This category includes such items as shops, machine sheds, and other general purpose buildings on a farm that are not integral to the manufacturing, production, or growing process.

Hoop structures generally fit in this category, in which they have a cost recovery period of 20 years. They are a general purpose farm building. This is likely the IRS's position. However, a fact-dependent argument can be made that a hoop structure is used as an integral part of production or is akin to a bulk storage facility used in connection with production. If that argument prevails, a hoop structure is IRC §1245 property with no class life.

Depreciation Method

A hoop structure that is used in a farming business (as defined in IRC §168(b)(2)(B)) must use the 150% declining-balance method rather than the 200% declining-balance method. The taxpayer's business determines the method available for depreciation, rather than the function of the equipment in the business.

Expense Method Depreciation

To be eligible for expense method depreciation under IRC §179, property must be acquired by purchase, used more than 50% in the active conduct of a trade or business, **and** be §1245 property that is either MACRS property or off-the-shelf computer software. Because a hoop structure is a general purpose agricultural building that is not §1245 real property, it is not eligible for expensing under §179 unless it is not a building and is an integral part of production like fences, drainage tile, machinery and equipment, etc., or is akin to a bulk storage facility.

It is difficult to argue that a hoop structure qualifies as a storage facility because of the hoop structure's adaptability to different uses. If such adaptation is economically reasonable and the structure provides working space in addition to storage space, a hoop structure will not qualify as bulk storage.[132]

> **Observation.** The IRS's view is **likely** to be that a hoop structure is a general-purpose agricultural building that is not eligible for IRC §179. The facts of an individual situation might change that conclusion, however.

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127. Treas. Reg. §1.48-1(e)(1)(i).

128. IRC §1245(a)(3)(B)(i).

129. *Olson v. Comm'r,* TC Memo 1970-296 (Oct. 22, 1970).

130. Ibid.

131. Ltr. Rul. 200013038 (Dec. 27, 1999).

132. See *Brown Williamson Tobacco Corporation v. U.S.,* 369 F.Supp. 1283 (W.D. Ky. 1973).

Bonus Depreciation

In general, property that is eligible for first year "bonus" depreciation (set at the 50% level for 2017) must have its original use commence with the taxpayer, be tangible depreciable property with a MACRS recovery period of 20 years or less[133] and not be "excepted" property (e.g., property that is not placed in service and disposed of in the same tax year or converted from business to personal use in the tax year that it was acquired). A hoop structure qualifies for bonus depreciation if its original use commenced with the taxpayer and it is not excepted property. Unless an election out of bonus depreciation is made, it is claimed before any applicable MACRS depreciation.

Observation. Fitting hoop structures within the existing framework for agricultural assets leads to the likely IRS conclusion that they are general purpose farm buildings with a cost recovery period of 20 years, ineligible for §179, and potentially eligible for first-year bonus depreciation. However, the facts of a particular situation could result in a determination that a hoop structure is §1245 real property with no class life that qualifies for §179 and is potentially eligible for first-year bonus depreciation.

Note. More information on §179 expensing and bonus depreciation is provided later in the chapter.

HANDLING DEPRECIATION ON ASSET TRADES

When a business (including an agribusiness or farm operation) buys an asset that has a useful life of more than a year, the business can depreciate the asset's cost over its life in order to recover the asset's gradual deterioration or obsolescence. If the business later sells the depreciated asset, it may be a taxable event if the asset is sold for more than its depreciated value. Taxpayers often look for ways to avoid reporting gain, including trading the asset in a nontaxable exchange. Computing depreciation on the property received in the exchange can be complicated, and accounting for depreciation recapture adds further complexity to the matter.

Observation. Sales of depreciated assets often result in taxable gain. The taxpayer may have elected to deduct some or all of the purchase price under §179 and/or claimed bonus depreciation on new assets, along with regular MACRS depreciation. In high-income years, many taxpayers claim the §179 deduction in the year of purchase, which results in no future depreciation deductions. Because the tax basis was fully expensed under §179, the sale of the asset generates gain. That gain would normally be capital gain but it is treated as ordinary income due to depreciation recapture.

Deferral Strategies

One way to defer gain recognition is to exchange the asset in accordance with IRC §1031. Asset exchanges can be very informal. For example, a simple exchange can involve an equipment trade-in. Agricultural equipment qualifies for tax-deferred exchanges for replacement agricultural equipment. Thus, a combine may be exchanged for a tractor and tillage equipment. Real estate qualifies for tax-deferred exchanges for other real estate, as long as neither the property given up nor the property received in the exchange is held as inventory for sale or as inventory of a developer. Whether the situation involves a simple trade-in of equipment or a more formal exchange of real estate, both result in the deferral of taxable income under §1031.

133. IRC §168(k).

There are two methods to compute the depreciation on replacement property.[134]

1. Add the remaining tax basis (i.e., the undepreciated portion) of the old property to the cost (after trade-in allowance) of the new property. Then, the replacement property is depreciated as one asset. Depreciation begins on the date the replacement property is placed in service.

2. Continue depreciating the old property over its remaining life, and depreciate the cost (after trade-in allowance) of the new property as a separate asset.

Note. For a thorough discussion of the depreciation rules for like-kind exchanges, see the 2011 *University of Illinois Federal Tax Workbook,* Chapter 1: Depreciation. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

The total depreciation to claim over the life of the replacement asset is the same under both methods. If the old asset was fully depreciated, there is no difference in the timing of depreciation deductions. However, if the old asset was not fully depreciated, the second method will provide larger depreciation deductions in the first year.

Sale of Replacement Asset

When the replacement asset is later sold, it could have a very low tax basis if the relinquished asset was fully or nearly fully depreciated. If it is sold for an amount greater than the amount reflected as its cost, a question arises as to the classification of the resulting gain. Depreciation claimed on equipment is recaptured upon the sale of the equipment, up to the amount of the total gain.[135] Gain in excess of the depreciation recapture is §1231 gain, which may be taxed as capital gain.

Example 4. John purchased a tractor in 1990 at a cost of $250,000. He traded it in when its basis was $40,000.The trade-in allowance was $150,000. The replacement tractor has a list price of $200,000 and John pays $50,000 after the trade-in. John puts the replacement tractor on the books at $90,000 ($50,000 trade-in cost + $40,000 remaining tax basis of old tractor). John sells the tractor for $120,000 later that year.

The "cost" of the tractor is listed on the depreciation schedule at $90,000, and the sales price is $120,000. However, the $30,000 excess is not a capital gain. The depreciation potential on the old tractor (the trade-in) carries over into the replacement tractor.[136] John's entire gain upon the sale of the replacement tractor is ordinary income due to §1245 depreciation recapture.

EXPENSE-METHOD DEPRECIATION AND BONUS DEPRECIATION

IRC §179 Expense Method Depreciation

For tangible depreciable personal property, all or part of the income tax basis can be deducted under IRC §179 in the year in which the property is placed in service (defined as when property is in a state of readiness for use in the taxpayer's trade or business),[137] regardless of the time of year the asset was placed in service. This allows the taxpayer to immediately expense the property rather than depreciate it over time.

134. Treas. Reg. §1.168(i)-6.

135. IRC §1245.

136. Treas. Reg. §1.1245-2(c)(4).

137. See, e.g., *Brown v. Comm'r,* TC Summ. Op. 2009-171 (Nov. 23, 2009).

Taxpayers (other than estates and trusts)[138] can elect to expense a certain amount of property each year. For tax years beginning in 2017, the maximum amount a taxpayer can expense under §179 is $510,000. The $510,000 limitation is reduced by the amount that the cost of §179 property placed in service during the 2017 tax year exceeds $2.03 million.[139]

Note. The maximum §179 deduction is $25,000 for heavy sport utility vehicles (SUVs). An SUV is considered "heavy" if it has a gross vehicle weight rating of more than 6,000 pounds.[140] Such vehicles are also eligible for first-year 50% bonus depreciation.

Note. IRC §179 expensing is based on the taxpayer's fiscal year (if different than the calendar year).

The IRC §179 expense-method depreciation amount is limited to the taxpayer's aggregate business taxable income that is derived from businesses that the taxpayer actively conducts during the tax year, with any disallowed amounts carried over to the next year.[141] "Active conduct" is defined by a facts-and-circumstances test that is used to determine if the taxpayer "meaningfully participates in the management or operations of the trade or business."[142] All wages and salaries of the taxpayer (and the taxpayer's spouse) are included in the aggregate amount of active business taxable income of the taxpayer.[143] The limitation applies at the entity level for pass-through entities in addition to also applying at the individual taxpayer level.[144] For married taxpayers who file jointly, the active business taxable income limitation is applied jointly.[145]

Partnerships and S Corporations. The §179 dollar limitation applies to partnerships and S corporations as well as to each individual owner.[146] When equipment ownership is shared, an informal partnership could result. In that event, a single §179 limitation applies to the equipment purchases. If a partnership does not result from such sharing arrangements, each individual co-owner is entitled to use their respective share of equipment purchases when calculating the §179 limit.

Note. For guidance in determining when co-ownership constitutes a partnership, see *Cusik v. Comm'r.*[147]

A partner is considered to actively conduct a business of the partnership if the partner meaningfully participates in the management or operations of the business.[148] Likewise, a shareholder in an S corporation is considered to actively conduct a business of the S corporation if the shareholder meaningfully participates in the management or operations of the business.[149]

138. IRC §179(d)(4).

139. Rev. Proc. 2016-55, 2016-45 IRB 707.

140. IRS Pub. 946, *How To Depreciate Property.*

141. IRC §179(b)(3)(B). This definition includes IRC §1231 gains and losses as well as interest from the working capital of the business. Treas. Reg. §1.179-2(c).

142. Treas. Reg. §1.179-2(c)(6)(ii).

143. Treas. Reg. §1.179-2(c)(6)(iv).

144. IRC §179(d)(8). This can be a particular concern in farming operations in which family members are sharing ownership of equipment. If a co-ownership arrangement is construed as a partnership, only one §179 limitation applies to equipment purchases. If the co-ownership is not a partnership, each taxpayer counts their respective share of equipment purchases for purposes of the §179 limitation.

145. Treas. Reg. §1.179-2(c)(7).

146. Treas. Reg. §§1.179- 2(b)(3)(i) and (4).

147. *Cusik v. Comm'r,* TC Memo 1998-286 (Aug. 5, 1998).

148. Treas. Reg. §1.179-2(c)(6)(ii).

149. Treas. Reg. §1.179-2(c)(3)(iii).

An S corporation's taxable income from the active conduct of a trade or business is determined by increasing business net income by the amount of deductions claimed for compensation to the shareholder-employees.[150] For a partnership, the taxable income limitation is determined after adding back deductions for guaranteed payments that are paid to the partners.[151]

Bonus Depreciation

Certain property is eligible for additional depreciation of up to 50% of the property's adjusted income tax basis for both regular income tax and alternative minimum tax (AMT) purposes for the first year the property is placed in service. Eligible property is property with a recovery period of 20 years or less, computer software, water utility property, and qualified improvement property.[152]

Eligible property must also be "new property," which means that the original use of the property must commence with the taxpayer.[153] Used machinery and equipment, "used" breeding or dairy animals, and buildings, fences, tile lines, and other improvements on a farm are not eligible.

> **Note.** When claiming the additional first-year depreciation, any §179 expense must be claimed first, then the bonus depreciation, followed by regular depreciation.

The taxpayer must either claim the 50% depreciation allowance on Form 4562, *Depreciation or Amortization,* or attach a statement to the return that the taxpayer is electing not to claim the 50% depreciation allowance. The taxpayer is treated as claiming the 50% additional first-year depreciation unless an election is made not to have the provision apply. If the election out is not made, the basis of eligible property is reduced as though the additional first-year depreciation had been taken.[154]

Legislation enacted into law in late 2015 continues the 50% first-year bonus depreciation allowance through 2017. The allowance decreases to 40% for 2018 and 30% for 2019. After 2019, it is presently scheduled to be eliminated.[155]

Example 5. Johnson Farms purchases new 5-year assets during 2017 costing $700,000. After claiming the maximum §179 deduction of $510,000, Johnson Farms then claims 50% bonus depreciation of $95,000 (($700,000 − $510,000) × 50%). The $95,000 of remaining basis is recovered under the normal depreciation rules, with another $14,250 allowable in 2017 (5-year, 150% declining-balance method, half-year convention). Johnson Farms claims a total of $619,250 ($510,000 IRC §179 expense + $95,000 bonus depreciation + $14,250 regular depreciation) of depreciation for the 2017 tax year.

Planning Opportunities

Farm taxpayers have numerous planning opportunities with respect to bonus depreciation and §179 expensing. Sometimes questions arise concerning whether certain assets qualify (usually tied to the MACRS classification of the asset). Other issues also raise opportunities for planning. The following list includes some of the more common planning tips for farm taxpayers.

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150. Treas. Reg. §1.179-2(c)(3)(ii).

151. Treas. Reg. §1.179-2(c)(2)(iv).

152. IRC §168(k). Qualified improvement property is defined as any improvement to an interior portion of nonresidential real property if the improvement is placed in service after the date the building was first placed in service, excluding enlargements, elevators/escalators and internal structural framework.

153. IRC §168(k)(2)(A)(ii).

154. Rev. Proc. 2015-48, 2015-40 IRB 469.

155. IRC §168(k)(6).

- General-purpose farm buildings, such as machine sheds and shops, are 20-year assets and qualify for 50% bonus depreciation if they are constructed and placed in service by the end of the calendar year.[156]
- A farm residence owned by a C corporation is a 20-year asset that qualifies for bonus depreciation.
- While the noncorporate lessor rules may bar §179 expensing for a farm landlord with respect to drainage tile, those rules do not apply to bonus depreciation.
- Property leased by noncorporate lessors to others is not eligible for IRC §179 unless the term of the lease is less than 50% of the class life of the property and during the first 12 months of the lease, the deductions of the lessor with respect to the property (other than taxes, interest, and depreciation) exceed 15% of the rental income produced by the property.[157] The rule is particularly troublesome for short-term unrelated party leases that are automatically renewed and real estate improvements that do not require repairs and maintenance. However, it may be possible to modify an existing lease to avoid the application of the noncorporate lessor rule.

Example 6. Ann is a farm landlord who needs to replace the irrigation pivot on her land. The terms of the 3-year lease called for rent of $300 per acre, with the tenant paying water and power costs of $70 per acre. Ann spends $100,000 to replace the irrigation pivot. Her expenses as a landlord (other than interest, taxes, and depreciation) do not approach the $45 ($300 × 15%) threshold she needs in order to meet the 15% test.

Ann and her tenant modify the rental arrangement so that Ann pays the water and power costs and the rent is adjusted to $370 per acre. Because the water and power costs of $70 per acre are greater than $55.50 (15% × $370) and the 3-year lease is for less than 50% of the 10-year class-life for agricultural equipment, Ann is allowed to claim the §179 deduction for the irrigation pivot against her rental income.

Note. If more than one property is subject to a single lease, an allocation of rent and expenses to each property is necessary.[158]

- Taxpayers may choose to utilize the §179 deduction in years that show a loss and carry the §179 amount to the following year.[159]
- For traded assets, both the boot and any adjusted tax basis of the relinquished asset qualify for bonus depreciation.[160] However, only the boot qualifies for the §179 deduction.
- The availability of bonus depreciation may impact the decision on which assets should be expensed under §179. To enhance the total depreciation deduction, §179 should be claimed on assets that do not qualify for bonus depreciation.
- If taxable income can be optimized without claiming all of the depreciation that could be claimed, the strategy could be to claim bonus depreciation and not claim some or all of what could be claimed under §179.

Note. IRC §179 expenses can be claimed or eliminated at a later date on an amended return for an open tax year. Situations in which an amended §179 election might be beneficial include: when the taxpayer receives income late in the year; when a previously deducted expense is capitalized; when §179 can be used to better position base period income for a current farm income averaging election; or when §179 expense can be removed to restore basis on an asset that is sold in the current year.

156. IRC §168(k).

157. IRC §179(d)(5).

158. Treas. Reg. §1.46-4(d)(3).

159. Treas. Reg. §1.179-3.

160. Treas. Reg. §1.168(k)-1(f)(5)(iii).

Tax Effects of Asset Sales. For §1245 assets, all associated depreciation expense is subject to recapture as ordinary income in the year of sale.[161] When §1250 property is sold, the amount of depreciation claimed in excess of straight-line is treated as ordinary income.[162] Bonus depreciation is an accelerated-depreciation method, rather than a straight-line method.[163] To the extent bonus depreciation exceeds straight-line depreciation, recapture results when the property is sold at a gain.[164]

> **Note.** Bonus depreciation is allowed for farm machine sheds and shops.[165] This type of property is listed in Rev. Proc. 87-56 as class 01.3 ("farm buildings"). This property is not §1245 property.[166]

> **Observation.** If a building has been held for over 20 years after being placed in service, §1250 recapture will be zero, because the straight-line depreciation and actual depreciation claimed will be the same amount. Consequently, the unrecaptured §1250 gain is subject to the maximum 25% capital gain rate upon disposition, up to the amount of total depreciation claimed. The excess gain is subject to regular capital gain rates.[167]

Conversion of Business Assets to Personal Use. If §179 expense is claimed for a business asset and that asset is converted to personal use because it is not used at least 50% for business purposes, the benefit of the IRC §179 election is recaptured.[168]

> **Note.** The amount of the recapture income from conversion to personal or investment use is reduced by the amount of depreciation that would have been allowable under IRC §168 if the §179 deduction had not been claimed.[169] However, bonus depreciation is considered regular depreciation under §168; therefore, conversion from business use does not cause a redetermination or recapture of the bonus depreciation amount.[170]

If conversion from business use would trigger §179 recapture, it might be avoided if the election can be reversed on an amended return. This might be advantageous if the property is eligible for bonus depreciation and an election out of bonus depreciation was not made.

> **Note.** A taxpayer can elect out of the bonus depreciation provision. The election out is made by asset class (in this case, by cost-recovery period — e.g., for all 3-year assets, for all 5-year assets, etc.).[171]

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161. IRC §1245(a)(1).
162. IRC §1250(a)(1)(A).
163. Treas. Reg. §1.168(k)-1(f)(3).
164. IRC §1245.
165. IRC §168(k)(2)(A)(i)(I).
166. IRC §1250(c).
167. IRC §1(h)(1)(D) and (E).
168. IRC §179(d)(10); Treas. Reg. §1.179-3(f)(2).
169. Treas. Reg. §1.179-1(e)(5).
170. Treas. Reg. §1.168(k)-1(f)(6)(iv).
171. IRC §168(k)(2)(D)(iii).

Example 7. Tammy bought a new tractor in 2013 and wrote off the tractor's entire purchase price under §179. In 2017, Tammy retired from farming but kept the tractor for personal use. Under normal §179 recapture rules, Tammy would have been entitled to retain about 4/7 of the §179 expense, because under normal depreciation rules she would have claimed regular depreciation deductions for approximately four years of the 7-year recovery period.

However, because the tractor was new in 2013, a year in which 50% bonus depreciation was available and because Tammy did not elect out of bonus depreciation, she is considered to have depreciated the tractor under regular depreciation during her period of ownership to the extent of 50% of the purchase price. IRC §179 recapture is triggered only as to the excess.

TAX-RELATED LOSS ISSUES IN AGRICULTURE

The Code provides assistance in dealing with farming losses — especially for taxpayers that are on the cash method (as is the case for most farmers). This is good news when faced with an economic downturn in the farm economy or an unexpected weather-related event.

NET OPERATING LOSS CARRYBACKS

For persons engaged in farming (cultivating of land or the raising or harvesting of any agricultural or horticultural commodity), the ability to elect to average farm income over the three prior years can be a very important income tax management tool. Although farm income averaging is normally used to apply lower income tax rates from prior years to the current year taxable income, it can work in reverse when income is low in the current year. When the election is made in this situation, the power of the technique lies in combining an income averaging election with the loss carryback rule.

Example 8. Joe has a large net Schedule F farming loss for 2017. Under the 5-year carryback rule that applies to farming losses, Joe can carry the loss back to his 2012 tax year. The tax year 2012 was a profitable year for Joe, and he was in one of the upper income tax brackets that year.

> **Note.** A beneficial aspect of the loss carryback rule is that a loss that is carried back to a prior year will offset the income in the highest income tax bracket first, and then the next highest, etc., until it is used up.[172]

If the loss carryback offsets all of Joe's income for the carryback year of 2012 before it is used up, the remaining carryback amount simply carries forward to 2013 and any later years.

> **Note.** This example shows that a loss from farming is not all bad news. It can generate an operating loss that can be carried back to generate an income tax refund for a prior year. However, net operating loss (NOL) carrybacks/carryforwards do not reduce SE income in the year the NOL deduction is taken.[173]

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

173. IRC §1402(a)(4).

A taxpayer has the option to carry a farming loss back two years instead of five years.[174] This is done by making an election to irrevocably forgo the 5-year carryback period for a farming loss.[175] Whether a taxpayer should make the election depends on the level of income in those carryback years and the applicable tax bracket. In addition, because two years (rather than five) involves open tax years, any §179 election that the taxpayer made in the prior two years can be revoked if the loss carryback eliminates the tax benefit for the election.

> **Note.** By revoking the §179 election, a taxpayer restores the income tax basis (to the extent of the election) for the item on which the §179 election was made. This allows a taxpayer to claim future depreciation deductions. This is the case, at least, on a taxpayer's federal return. However, some states "decouple" from the federal §179 provision.

For a carried-back loss that triggers a refund, the rules governing how the tax is calculated for an income averaging election are important. An NOL that is carried over to a year for which the election applies (or a net capital loss carryover to an election year) is applied to that year's income before elected farm income (EFI) is subtracted. EFI, which is averaged over the prior three years, is the amount of taxable income attributable to any farming business that is specifically elected by the taxpayer as subject to income averaging. An NOL carryover that is partially applied in that base year is not recomputed to offset EFI that is added to that year because of the election.

The following points should be considered when calculating EFI.

- EFI is subtracted after making a determination as to whether aggregate sales (and other dispositions) of business property generate long-term capital gain or an ordinary loss under IRC §1231.
- When EFI includes capital gain and those gains are shifted to a base year that has a capital loss, there is no offset of the unused capital loss. The gains are taxed at the lesser of the prior year's maximum capital gain rate or the regular tax rate.[176]

EXCESS FARM LOSSES

The 2008 Farm Bill included a provision that limits the deductibility of an "excess farm loss" after 2009 for farmers who do not operate as a C corporation and who receive any applicable subsidy for the tax year.[177] **Applicable subsidies** include direct or counter-cyclical payments from the U.S. Department of Agriculture (USDA), any payments elected to be received in lieu of a direct or counter-cyclical payment, or any Commodity Credit Corporation (CCC) loans.[178] Conservation Reserve Program (CRP) payments are not deemed to be a subsidy payment for purposes of this provision.

The excess farm loss is calculated as:

- The excess of the aggregate deductions of the farmer for the year attributable to the farming business over the sum of the aggregate gross income or gain of the farmer for the year attributable to farming, plus
- A threshold amount (defined as the greater of $300,000 for individuals who are married filing jointly (MFJ) or the total of the net farm income for the previous five years).[179]

> **Note.** For more information about excess farm losses, see the 2016 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 7: Agricultural Issues and Rural Investments.

174. Ibid.
175. IRC §172(i)(3).
176. Treas. Reg. §1.1301-1(d)(1).
177. IRC §461(j)(1).
178. IRC §461(j)(3).
179. IRC §461(j)(4).

The 2014 Farm Bill repealed direct and counter-cyclical payments. Thus, the only type of subsidy that would potentially limit a farmer's ability to deduct losses is a CCC loan. Loan deficiency payments would appear to not be an applicable subsidy for purposes of the provision.

Moreover, for purposes of the rule, losses arising from fire, storm, or any other casualty, or because of disease or drought are not subject to the limitation.

LIVESTOCK INDEMNITY PROGRAM PAYMENTS

The Livestock Indemnity Program (LIP), administered by the USDA's Farm Service Agency (FSA), was created under the 2014 Farm Bill to provide benefits to livestock producers for livestock deaths that exceed normal mortality caused by adverse weather, among other things. The amount of an LIP payment is set at 75% of the market value of the livestock at issue on the day before the date of death, as the Secretary of Agriculture determines.

Eligible livestock include beef bulls and cows, buffalo, beefalo, and dairy cows and bulls. Non-adult beef cattle, beefalo, and buffalo are also eligible livestock. The livestock must have died within 60 calendar days from the ending date of the applicable adverse weather event and in the calendar year for which benefits are requested. To be eligible, the livestock must also have been used in a farming or ranching operation as of the date of death.

Contract growers of livestock are also eligible for LIP payments. LIP payments cannot be made for wild animals, pets, or animals that are used for recreational purposes (e.g., hunting dogs, etc.).

Payments

As noted earlier, LIP payments are set at 75% of the market value of the livestock as of the day before their death. That market value is tied to a "national payment rate" for each eligible livestock category as published by the USDA. For contract growers, the LIP national payment rate is based on 75% of the average income loss sustained by the contract grower for the livestock that died. Any LIP payment that a contract grower receives is reduced by the amount of monetary compensation that the grower received from the grower's contractor for the loss of income sustained from the death of the livestock grown under contract.[180]

Federal Farm Program Payment Limitations

A $125,000 annual FSA payment limitation applies for combined payments under the LIP, Livestock Forage Program, and the Emergency Assistance for Livestock, Honey Bees and Farm-Raised Fish Program. An eligible farmer or rancher is one that has average adjusted gross income (AGI) over an applicable 3-year period that does not exceed $900,000.[181] For 2017, the applicable 3-year period is 2013–2015.

For a particular producer, tax planning strategies to keep average AGI at or under $900,000 may be needed. This could include the use of deferral strategies, income averaging, and amending returns to make or revoke a §179 election.

Documenting the Loss

An eligible producer can submit a notice of loss and an application for LIP payments to the local FSA office. The notice of loss must be submitted within the earlier of 30 days of when the loss occurred (or became apparent) or 30 days after the end of the calendar year in which the livestock loss occurred. For contract growers, a copy of the grower contract must be provided.[182]

For all producers, it is important to submit evidence of the loss supporting the claim for payment. Photographs, veterinarian records, purchase records, loan documentation, tax records, and similar data can be helpful in documenting losses. The weather event triggering the livestock losses must also be documented. In addition, certification of livestock deaths can be made by third parties on Form CCC-854, *Third Party Certification,* if certain conditions are satisfied.

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180. FR Vol. 79, No. 71 (Apr. 14, 2014).

181. Ibid.

182. Ibid.

Tax Reporting

Given that wildfires occurred in areas of Kansas, Oklahoma, and Texas in the early part of 2017, it is likely that LIP payments will be received in 2017. However, LIP payments are not always received in the same year that the excess livestock deaths occur. Sometimes, LIP payments are not paid until the calendar year after the year in which the loss was sustained. For example, livestock losses in South Dakota a few years ago occurred late in the year, and payments were not received until the following year.

> **Observation.** The FSA issues a Form 1099-G, *Certain Government Payments,* for the full amount of the LIP payment.

Death of Breeding Livestock

Although Form 1099-G simply reports the gross amount of any LIP payment to a producer for the year, there may be situations in which a portion of the payment is compensation for the death of breeding livestock. If the producer had sold the breeding livestock, the sale would have triggered IRC §1231 gain that would have been reported on Form 4797, *Sales of Business Property.*

This raises a question as to whether it is possible to allocate the portion of the disaster proceeds allocable to breeding livestock from Schedule F to Form 4797. This is an issue for many producers who have sustained livestock losses. Although it is true that gains and losses from the sale of breeding livestock sales are reported on Form 4797, the IRS expects Form 1099-G amounts paid for livestock losses to be reported on Schedule F (most likely on line 4a).

Income Inclusion and Deferral

Generally, any benefits associated with indemnity payments (or feed assistance) are reported in income in the tax year that they are received. This means, for example, that payments received in 2017 for livestock losses occurring in 2017 are reported on the 2017 return. Likewise, payments for livestock losses occurring in 2016 that were received in 2017 are also reported on the 2017 return.

If a livestock producer receives and includes LIP payments in income in 2017, this could put the producer in a higher income tax bracket for 2017. In that situation, there may be other tax rules that can be used to defer the income associated with the livestock losses. Under IRC §451(e), the proceeds of livestock that are sold on account of weather-related conditions can be deferred for one year. Under IRC §1033(e), the income from sales of livestock held for draft, dairy, or breeding purposes that are involuntarily converted due to weather can be deferred if the livestock are replaced with like-kind livestock within four years. The provision applies to the amount that the livestock sales exceed sales that would occur in the course of normal business practices.

Although §451(e) requires that a sale or exchange of the livestock must have occurred, this is not the case for the receipt of indemnity payments for livestock losses. **There is no deferral opportunity with respect to LIP payments.** However, the involuntary conversion rule of §1033(e) is structured differently. It does not require a sale or exchange of the livestock but allows a deferral opportunity until animals are acquired to replace the (excess) ones lost in the weather-related event. Thus, only the general involuntary conversion rule of §1033(a) applies rather than the special one for livestock when a producer receives indemnity (or insurance) payments due to livestock deaths.

LIP payments received in 2017 must be reported unless the recipient acquires replacement livestock within the next two years (by the end of 2019). Any associated gain would then be deferred until the replacement livestock are sold. At that time, any associated gain would be reported, and the gain on the replacement animals attributable to breeding stock is reported on Form 4797.

SCHEDULE J TO MANAGE FARM INCOME

An individual engaged in a farming (or fishing) business can elect to spread the portion of current taxable income attributable to any farming business (EFI) evenly over the three prior tax years by using Schedule J, *Income Averaging for Farmers and Fishermen.* Thus, if rates were lower in the prior years, a taxpayer can benefit from applying the lower rates to current taxable income from farming. The current year's income tax liability is calculated by determining the current year's tax (without the EFI), plus the increases in income tax for each of the three prior tax years, by taking into account the allocable share of EFI for each of those years. Adjustments for any tax year are taken into account for income averaging purposes in subsequent tax years.[183]

BASICS OF AVERAGING

Eligibility

Only individuals with farm (or fishing) income are eligible to use income averaging.[184] Estates, trusts, and C corporations are not eligible. For entities taxed as partnerships, the individual partners or members, rather than the partnership, may be eligible to elect income averaging. An S corporation engaged in farming is not eligible to make an income averaging election, but the S corporation individual shareholder may be eligible. Likewise, income attributable to a farming business carried on by a partnership can be averaged without regard to the partner's level of participation in the partnership or the size of the ownership interest.

Engaged In A Farming Business

An individual electing income averaging must be "engaged in a farming business" in the year for which the election is made.[185] However, the individual is not required to have been engaged in a farming business in the three prior carryback years. A **farming business** is a trade or business involving the cultivation of the land or the raising and harvesting of agricultural or horticultural commodities. It does not include the processing of commodities or products "beyond those activities which are normally incident to the growing, raising or harvesting of such products."[186]

An individual's relationship to the farming business is critical in determining eligibility. Operators of farming businesses who bear the risks of production and the risks of price change and are substantially involved in management are clearly eligible for income averaging. A landlord is engaged in a rental activity and not in a farming business if the rental is a fixed rent (cash rent). Whether the landlord materially participates in the tenant's farming business is irrelevant for income averaging purposes.

> **Note.** Although the landlord's material participation is irrelevant, non-materially participating landlords are only eligible for income averaging if the landlord's share of a tenant's production is set in a written rental agreement before the tenant begins significant activities on the land.[187] Taxpayers filing Form 4835, *Farm Rental Income and Expenses,* are eligible for income averaging.

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183. IRC §1301.

184. Ibid.

185. Ibid.

186. Treas. Reg. §1.263A-(a)4(ii)(B).

187. Treas. Reg. §1.1301-1(b)(2).

Retired Farmers

Individuals are not engaged in a farming business during a year in which they have ceased farming operations and their only activity in the year in question is the sale of inventory and machinery. However, gains or losses from property regularly used in a farming business after cessation of the business are treated as attributable to a farming business if the property is sold within a reasonable time after cessation of the business. If the sale or other disposition of such assets occurs within **one year** of the cessation of farming, it is presumed to be within a reasonable time. After that, the determination of whether a sale or other disposition occurred within a reasonable time depends on all the facts and circumstances.[188]

Are Gains Eligible?

Gains from the "sale or other disposition of property (other than land) regularly used by the taxpayer in such a farming business for a substantial period" are eligible for averaging.[189] Gains from the sale or exchange of land do not qualify. Although not completely clear, it would appear that gain from land sales is ineligible for averaging whether that gain is taxed as capital gain, ordinary income, recaptured depreciation, unrecaptured §1250 gain, and when the gain is attributable to the soil.

Note. The IRS's position is that gains from assets considered to be part of the land (e.g., buildings, fences, and tile lines) are eligible for income averaging.[190]

Calculating The Tax

Under the farm income averaging rules, the Code provides that the tax imposed for the year in which income averaging is elected is the sum of the tax for that year on income reduced by the amount of the EFI, plus the increase in tax that would have occurred if taxable income for each of the three previous tax years was increased by an amount equal to one-third of EFI.[191] In addition, any adjustment to taxable income for a prior year because of the EFI amount averaged to that tax year is taken into account in applying the income averaging provision for any subsequent tax year.

Example 9. Mike files a joint return and meets the requirements for making an income averaging election.[192] Mike elected to apply income averaging to $27,000 of income in 2014 and to $66,000 of income in 2015. His adjustments to taxable income for the 2014 averaging must be taken into account before applying the adjustments for the 2015 averaging. This is shown in the following table.

	2011	2012	2013	2014	2015
Base income	$20,000	$20,000	$20,000	$55,000	$117,000
Averaging applied to $27,000 of 2014 income	9,000	9,000	9,000	(27,000)	
Subtotal	$29,000	$29,000	$29,000	$28,000	
Averaging applied to $66,000 of 2015 income		22,000	22,000	22,000	(66,000)
Income after adjustments	$29,000	$51,000	$51,000	$50,000	$ 51,000

188. Treas. Reg. §1.1301-1(e)(1)(ii)(B).

189. IRC §1301(b)(1)(B).

190. Treas. Reg. §1.1301-1(e)(1)(ii)(A).

191. IRC §1301(a).

192. Example courtesy of Chris Hesse, Principal, CliftonLarsonAllen.

The income of the past years is adjusted upward for a future year's computation **after** income averaging has been used. Thus, farm income averaging does not change the taxable income or tax of any of the three base years. It does not cause the current year's income to be added to the income from a base year. The income averaging election simply uses the prior 3-year tax base to determine the rate for the year of the election. Any applicable phase-outs or percentage limitations for the base years are not affected.[193]

Based on the facts of **Example 9,** the tax practitioner might achieve a better tax result by amending the 2014 and 2015 tax returns to obtain more benefit from the income averaging election. The taxpayer reduces the applicable tax rate for 2014 and 2015 (for Mike in the example, 2013 is a closed year that is not part of the base years for the income averaging calculation).

> **Observation.** The combination of the income averaging election with a loss carryback can be helpful in a difficult financial year that follows a couple of profitable years.

Tax Planning

Phaseouts, Rates, and Limitations. Income averaging does not affect the taxable income or tax of any of the three base years.[194] It is not a "carryback" of current income to the base year. Instead, income averaging just refers to the base year's marginal income tax rate for the purpose of applying that rate to a portion of current year taxable income. This means that income averaging does not change the phase-outs or percentage limitations of the base year tax returns. Moreover, when tax rates go up, if everything else stays the same, an income averaging election can benefit taxpayers in the upper tax brackets. In this situation, the election will always reduce the tax rate.

> **Observation.** When tax rates increased starting in 2013, taxpayers in the upper tax brackets benefited from income averaging for 2013, 2014, and 2015.

Capital Gain Rate Reduction. The averaging election can be made on both ordinary and capital gains, but IRS Pub. 225 indicates that an equal portion of each type of income must be carried to each prior year. From a tax planning standpoint, an income averaging election can be made on ordinary income and, with proper planning, the effective rate on nonfarm capital gains can be reduced. When the top capital gain rate increased to 20% beginning in 2013, the averaging election can have the effect of reducing the rate to 15%. It also could, perhaps, eliminate it. This could result in significant savings for a farmer that sells breeding stock or other assets that trigger capital gain.

Example 10. Juanita and Jerry file a joint return.[195] For 2017, she has taxable income of $80,000 consisting of $75,000 of ordinary farm income and $5,000 of capital gains from the sale of securities. For the prior three base years, Juanita and Jerry's joint taxable income has been consistently about $40,000. Without an income averaging election, Juanita's $5,000 of long-term capital gains will be taxed at 15% because the ordinary income is considered to first fill up the lower 15% tax rate bracket, which ends at $75,900 of taxable income for 2017.[196] The capital gain, considered to be the last income, is taxed at 15%.

If Juanita makes an income averaging election and designates $5,000 of her ordinary farm income as EFI, it will reduce her 2017 taxable income from $80,000 to $75,000. She saves no ordinary income tax because the top ordinary income tax rate is 15% in both the current and three base years. However, by reducing the current year taxable income to below the top of the 15% ordinary bracket, the $5,000 of capital gains is taxed at 0% rather than 15%. Thus, the election saves $750 ($5,000 × 15%) of federal tax.

193. Treas. Reg. §1.1301-1(d)(1).

194. Ibid.

195. Example courtesy of Chris Hesse, Principal, CliftonLarsonAllen.

196. Rev. Proc. 2016-55, 2016-45 IRB 707.

Alternative Minimum Tax. The income averaging election has no direct impact on how the AMT is calculated. The taxpayer cannot "average" the AMT calculation.[197] However, a tax benefit can be derived if a farmer makes the averaging election in a year in which they are subject to AMT. In addition, an increase in taxable income might decrease the AMT. In that event, the marginal tax rate for top bracket farmers will drop. Likewise, it is possible that AMT income might exceed the phase-out of the AMT exemption and that the tentative minimum tax might exceed the regular income tax both before and after adding incremental income. In that situation, the AMT will decline. Also, because there is no AMT floor on the use of averaging, the election can be quite beneficial in a year when a farmer has an income spike (maybe from a machinery sale or because a large amount of carryover grain is sold, especially at high prices). In addition, planning opportunities may exist when the farmer has substantial nonbusiness expenses that exceed nonbusiness income in the base years.

AMT is determined by comparing tentative minimum tax and regular tax before considering reductions in the regular tax from the election.[198]

> **Example 11.** Tom has dependent children, and he ranches in California, which has a high state income tax.[199] After claiming personal exemptions and state income tax deductions, Tom's regular income tax is $27,000 and his tentative minimum tax is $30,000. Tom is liable for $3,000 ($30,000 − $27,000) of AMT. However, with an income averaging election, Tom decreases his regular tax to $20,000. Consequently, his total tax is $23,000 ($20,000 regular tax + $3,000 AMT).

Other Tax Provisions. Many other tax provisions can be impacted by an averaging election. Some of the more common items follow.

- An income averaging election does not affect SE tax. It only affects income tax. However, if the taxpayer files an amended return to reduce income below the social security earnings base, an SE tax refund can be obtained. In that event, Schedule J is not impacted other than for income tax purposes.
- If the "kiddie tax" election is made on the parents' return, the child's investment income is subject to the parents' rate after shifting the EFI. However, in the base years, the kiddie tax is not affected by the election.[200]
- Any NOL carryovers or net capital loss carryovers to an election year are applied to the election year income **before** the EFI is subtracted.[201] The election could create a tax advantage.
- An individual is not prohibited from making an income averaging election solely because their filing status is not the same as in the base years.[202]

> **Note.** The IRS has not provided guidance on how the remaining bracket amounts are to be divided between the spouses if both spouses have elected income averaging in a year following their divorce.

- Negative amounts can be utilized. This is good news for many farmers that are presently experiencing tough economic times. However, it appears that negative EFI amounts in the year of election cannot be used to reduce tax liability as calculated with reference to the three carryback years.[203]
- An income averaging election can be made on a late or amended return if the period of limitations on filing a claim for credit or refund has not expired. Also, a previous election can be changed or revoked if the period of limitations has not expired.[204] This feature provides flexibility in using the election.

197. Treas. Reg. §1.1301-1(f)(4).
198. IRC §55(c)(2).
199. Example courtesy of Chris Hesse, Principal, CliftonLarsonAllen.
200. Treas. Reg. §1.1301-1(f)(5).
201. Treas. Reg. §1.1301-1(d).
202. Treas. Reg. §1.1301-1(f)(2).
203. Treas. Reg. §1.1301-1(d)(2).
204. Treas. Reg. §1.1301-1(c).

Other Opportunities. Farm income averaging can provide a significant tax savings for farm (and fishing) clients in certain situations. The following are situations that typically work well for a farm income averaging election.

- A retiring farmer with carryover grain sales and/or income from a machinery auction
- Situations in which it is worth causing farm income to spike periodically (every three to four years) to avoid SE tax (because part of SE income is over the social security base amount), while simultaneously lowering income tax costs by an election
- Taxpayers who are in higher tax brackets
- Electing farm income averaging that only results in a de minimis change in the tax liability for the current year but moves farm income to the previous three years. This strategy creates a lesser amount of taxable income attributable to the current tax year that may be beneficial in a future tax year.

FINANCIAL DISTRESS

The financial situation in the agricultural economy has changed considerably over the last few years. For instance, in Kansas, average net farm income in 2015 was the lowest since 1981.[205] Crop prices are down and the cost of production has gone up. This has had a significant impact on many farmers' ability to repay debt. Repayment capacity is an important issue, and an erosion of a farmer's working capital negatively impacts financing.

CHAPTER 12 BANKRUPTCY

Debt restructuring can be accomplished by filing a Chapter 12 bankruptcy petition. Chapter 12 is a special part of the bankruptcy code applicable to "family farmers."

Family Farmer

To be eligible for Chapter 12 bankruptcy, a debtor must be a family farmer or a family fisherman with regular annual income.[206] A **family farmer** is defined as an individual or an individual and their spouse who earned more than 50% of their gross income from farming either for the tax year preceding the year of filing or during the second and third tax years preceding the year of filing.[207] This is the farm income test (explained in detail later). A different rule applies to a **family fisherman.**[208]

Additionally, the family farmer's aggregate debts must not exceed $4,153,150[209] (a lower threshold applies for a family fisherman). More than 80% of the debt must be connected with a farming operation that the debtor owns or operates. The term **farming operation** includes farming, tillage of the soil, dairy farming, ranching, production or raising of crops, poultry, or livestock, and production of poultry or livestock products in an unmanufactured state.[210]

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205. *Net Farm Income by Decile Group.* Ibendahl, Gregg. Sep. 14, 2016. Kansas State University. [www.agmanager.info/net-farm- income-decile-group] Accessed on May 31, 2017.

206. 11 USC §101(19).

207. 11 USC §101(18).

208. 11 USC §101(19)(A).

209. 11 USC §101(18) as adjusted by 11 USC §104. The debt limit is adjusted for inflation at 3-year intervals and was last adjusted on Apr. 1, 2016.

210. 11 USC §101(21).

Farm Income Test

As mentioned previously, to be eligible for Chapter 12 bankruptcy, more than 50% of an **individual debtor's** gross income must come from farming in either the year before filing or in both the second and third tax years preceding the year of filing. This provision seeks to disqualify tax-shelter and recreational farms from Chapter 12 protection and is applied at the time of bankruptcy filing. Thus, the debtor must be a farmer engaged in farming at the time the petition is filed, and a determination of whether the debtor has the intent to continue farming is made at that time. However, there is no specific requirement in the Bankruptcy Code that the income to fund the Chapter 12 reorganization plan come specifically from farming. The income only needs to be stable and regular.[211]

INCOME EXCLUSION OF FORGIVEN DEBT

General Rule

Except for debt associated with installment land contracts and CCC loans, most farm debt is recourse debt. With recourse debt, the collateral stands as security on a loan. If the collateral is insufficient to pay off the debt, the debtor is personally liable on the obligation and the debtor's nonexempt assets are reachable to satisfy any deficiency.[212]

When a debtor relinquishes property, the income tax consequences involve a 2-step process. Essentially, the property is sold to the creditor, and the sale proceeds are applied to the debt. There is no gain or loss (and no other income tax consequence) up to the income tax basis on the property. The difference between FMV and the income tax basis is gain or loss. Finally, if the indebtedness exceeds the property's FMV, the debtor remains liable for the difference. Any amount that is forgiven is discharge-of-indebtedness income.

> **Note.** Under IRC §§108(a)(1)(A)–(C), a debtor is not required to include in gross income any discharge of indebtedness if the discharge occurs as part of a bankruptcy case or when the debtor is insolvent, or if the discharge is of **qualified farm debt.** If one of these provisions excludes the debt from income, Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment),* must be completed and filed with the return for the year of discharge.

Qualified Farm Indebtedness

Qualified farm indebtedness is debt incurred directly in connection with the taxpayer's operation of a farming business. In addition, at least 50% of the taxpayer's aggregate gross receipts for the three tax years immediately preceding the tax year of the discharge must arise from the trade or business of farming.[213]

A debtor engaged in the trade or business of farming is not required to include in gross income qualified farm indebtedness that is discharged via an agreement with a "qualified person." A **qualified person** includes a lender that is actively and regularly engaged in the business of lending money and is **not:**

- Related to the debtor or to the seller of the property,
- A person from which the taxpayer acquired the property, or
- A person who receives a fee with respect to the taxpayer's investment in the property.[214]

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211. In *In re Williams,* No. 15-11023(1)(12) (Bankr. W.D. Ky. 2016), the court noted that 11 USC §101(19) requires a debtor to have regular income sufficient to enable the debtor to make plan payments and that its definition of "family farmer with regular income" meant that the income only be sufficiently stable and regular to enable the debtor to make plan payments. It did not require the income to be generated from farming activities. So, the debtors did not have to be engaged in farming at the time they filed Chapter 12 and, apparently, they also did not have to intend to return to farming.

212. *Recourse vs. Nonrecourse Debt.* IRS. [https://apps.irs.gov/app/vita/content/36/36_02_020.jsp] Accessed on May 19, 2017.

213. IRC §§108(g)(2)(A)–(B).

214. IRC §49(a)(1)(D)(iv).

Under IRC §108(g)(1)(B), a qualified person also includes federal, state, or local governments or their agencies.

> **Observation.** Nonfarm income and passive rental arrangements can cause complications in meeting the gross receipts test.

Solvency. The qualified farm debt exclusion rule does not apply if the debtor is insolvent or is in bankruptcy. Debtors other than farmers have income from the discharge of indebtedness if they are solvent.[215]

The determination of a taxpayer's insolvency is made immediately before the discharge of indebtedness. "Insolvency" is defined as the excess of liabilities over the FMV of the debtor's assets.[216] Both tangible and intangible assets are included in the calculation. In addition, both recourse and nonrecourse liabilities are included in the calculation but contingent liabilities are not. The separate assets of the debtor's spouse are not included in determining the extent of the taxpayer's insolvency.

> **Note.** Property exempt from creditors under state law is included in the insolvency calculation.[217]

Maximum Amount Discharged.[218] There is a limit on the amount of discharged debt that can be excluded from income under the qualified farm debt exception. The excluded amount cannot exceed the sum of the taxpayer's adjusted tax attributes and the aggregate adjusted bases of the taxpayer's depreciable property that the taxpayer holds as of the beginning of the tax year following the year of the discharge.

Reduction of Tax Attributes. The debt that is discharged and which is excluded from the taxpayer's gross income reduces the debtor's tax attributes.[219] Unless the taxpayer elects to reduce the basis of depreciable property first, §108(b)(2) sets forth the general order of tax attribute reduction (which occurs after computing tax for the year of discharge[220]). The order is as follows.

1. NOLs for the year of discharge as well as NOLs carried over to the discharge year
2. General business credit carryovers
3. Minimum tax credits
4. Capital losses for the year of discharge and capital losses carried over to the year of discharge
5. The basis of the taxpayer's depreciable and nondepreciable assets
6. Passive activity loss and credit carryovers
7. Foreign tax credit carryovers

> **Note.** The attributes that can be carried back to tax years before the year of discharge are accounted for in those carryback years before they are reduced. Likewise, any reductions of NOLs or capital losses and carryovers first occur in the tax year of discharge followed by the tax year in which they arose.[221]

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215. IRS Pub. 225, *Farmer's Tax Guide;* IRC §108(a)(1).

216. Ibid.

217. *Carlson v. Comm'r,* 116 TC 87 (Feb. 23, 2001).

218. IRC §108(g)(3)(A)(i-ii).

219. IRC §108(b)(1).

220. IRC §108(b)(4)(A).

221. IRC §108(b).

The tax attributes are generally reduced on a dollar-for-dollar basis (i.e., one dollar of attribute reduction for every dollar of exclusion). However, any general business credit carryover, minimum tax credit, foreign tax credit carryover, or passive activity loss carryover is reduced by 33.33 cents for every dollar excluded.[222]

If the amount of income that is excluded is greater than the taxpayer's tax attributes, the excess is permanently excluded from the debtor's gross income and is of no tax consequence. If the taxpayer's tax attributes are insufficient to offset all of the discharge of indebtedness, the balance reduces the basis of the debtor's assets as of the beginning of the tax year of discharge.[223]

Discharged debt that would otherwise be applied to reduce basis in accordance with the general attribute reduction rules specified above and that also constitutes qualified farm indebtedness is applied only to reduce the basis of the taxpayer's qualified property.[224] **Qualified property** is defined as any property used or held for use in a trade or business or for the production of income.[225] The basis reduction to the qualified property is applied in the following order.[226]

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

This is the basis reduction order unless the taxpayer elects to have any portion of the discharged amount applied first to reduce the basis in the taxpayer's depreciable property, including real property held as inventory.[227]

Purchase Price Adjustment. Instead of triggering discharge of indebtedness income, if the original buyer and the original seller agree to a price reduction of a purchased asset at a time when the original buyer is not in bankruptcy or insolvent, the amount of the reduction does not have to be reported as discharge of indebtedness income.[228] The seller also has no immediate adverse tax consequences from the discharge. Instead, the profit ratio that is applied to future installment payments is affected.[229]

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222. IRC §108(b)(3)(B).
223. Treas. Reg. §1.108-7(a)(2).
224. IRC §1017(b)(4)(A).
225. IRC §108(g)(3)(C).
226. Ibid.
227. IRC §§108(b)(5)(A) and 1017(b)(3)(E).
228. IRC §108(e)(5)(A).
229. Ltr. Rul. 8739045 (Jun. 30, 1987).