Chapter 7: Agricultural Issues and Rural Investments

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Please note. Corrections were made to this workbook through January of 2019. 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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AG-RELATED PROVISIONS IN THE TAX CUTS AND JOBS ACT

COMMODITY GIFTS

For tax years beginning before 2018, a parent could gift grain to a child and eliminate self-employment (SE) tax on the gifted grain. In addition, under the "kiddie-tax" rules, the tax rate of the child was generally the parent's rate. However, under the Tax Cuts and Jobs Act (TCJA), in most situations, the child's tax rate for unearned income is the rate applicable to estates and trusts.[1] Accordingly, for 2018, the applicable tax rate is 37% on all of the child's unearned income over $12,500.[2] This provision is applicable for tax years beginning after 2017 and before 2026.

Observation. Given the increased standard deduction under TCJA and the elimination of many itemized deductions, farmers may realize greater tax savings by contributing commodities to a qualified charitable organization.

DEDUCTION FOR STATE AND LOCAL PROPERTY TAXES

For tax years beginning after 2017 and before 2026, state, local, and foreign property taxes and state and local sales taxes are allowed as a deduction by an individual without limitation only when paid or accrued in carrying on a trade or business, or in an activity that produces income. Thus, only those deductions for state, local, and foreign property taxes and sales taxes that are presently deductible in computing income on an individual's Schedule C, *Profit or Loss From Business;* Schedule E, *Supplemental Income and Loss;* or Schedule F, *Profit or Loss From Farming,* are allowed without limitation. A $10,000 limit is imposed for state and local **property** taxes that are not paid or accrued in carrying on a trade or business or in an income-producing activity, and for state and local **income** taxes.[3]

Example 1. Bob and Sally own a home in Oblong, Illinois. The real estate tax on their home is $2,100. They also pay $8,750 of Illinois state income tax. Thus, their total real estate tax and state income tax is $10,850. The maximum deduction that they can claim in 2018 on Schedule A, *Itemized Deductions,* for these taxes is limited to $10,000.

1. TCJA §11001, modifying IRC §1(g)(1).
2. Rev. Proc. 2018-18, 2018-10 IRB 392 (§3.01).
3. TCJA §11042, modifying IRC §164(b).

The $10,000 limit **does not apply** to real estate taxes paid on **farm property.**[4] It is immaterial how the farmland is owned, whether by an individual or via an entity.

Example 2. Jerry and Lisa own a farm near Goofy Ridge, Illinois. Part of the farmland is owned by an S corporation in which Jerry and Lisa are the shareholders. Part of the farmland is owned by an LLC that Jerry and Lisa own. The couple also owns part of the farmland individually. The S corporation pays $15,000 of real estate taxes. The LLC pays $8,000 of real estate taxes. Jerry and Lisa pay another $9,000 of real estate taxes. All of the taxes are deductible. The $10,000 limit does not apply to the farmland.

Observation. Only real estate taxes on the taxpayer's personal residence (or vacation home) are limited. Real estate taxes that are paid on farmland used in a farming business remain fully deductible.

LOSS LIMITATION FOR NONCORPORATE TAXPAYERS[5]

Excess Business Loss Rule

For tax years beginning after December 31, 2017, and before January 1, 2026, **excess business losses** of a taxpayer other than a corporation are **not allowed** for the tax year. An excess business loss is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer (determined without regard to the limitation of the provision), over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount.

The threshold amount for a tax year is $500,000 for married taxpayers filing jointly (MFJ) and $250,000 for other taxpayers. These threshold amounts are indexed for inflation.

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Note. The TCJA eliminated a provision limiting the deductibility of farm losses in excess of $300,000 (generally) and replaced it with the provision limiting all business losses (farm and nonfarm) to $250,000 ($500,000 for MFJ taxpayers).

In the case of a partnership or S corporation, the provision applies at the partner or shareholder level. Each partner's distributive share and each S corporation shareholder's pro rata share of items of income, gain, deduction, or loss of the partnership or S corporation are taken into account in applying the limitation for the tax year of the partner or S corporation shareholder.

Note. For purposes of the excess business loss rule, the aggregate amount of business income from multiple businesses is combined, and up to $500,000 (for an MFJ taxpayer) can be used to offset other income. If the net amount of loss exceeds $500,000, the excess is carried forward. In addition, IRC §1231 gains are business income and, as such, offset business losses.

Note. For examples illustrating the excess business loss rule, see the 2018 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: Individual Taxpayer Issues.

4. TCJA §11042, modifying IRC §164.

5. TCJA §11012, modifying IRC §461.

Net Operating Losses

The TCJA made changes affecting how farmers can treat net operating losses (NOLs). For tax years beginning after 2017 and before 2026, a **noncorporate farm taxpayer** is limited to carrying back NOLs of up to $500,000 for MFJ taxpayers and $250,000 for all other taxpayers.[6] NOLs exceeding the threshold must be carried forward to the following year.[7]

For tax years beginning after December 31, 2017, NOLs can be carried forward indefinitely (as opposed to being limited to a 20-year carryforward under prior law). However, they can only offset the lesser of the aggregate NOL carryovers to the tax year, plus the NOL carrybacks to the tax year, or 80% of taxable income computed without regard to the NOL deduction (the former rule allowed a 100% offset).[8]

In addition, effective for tax years **ending after** December 31, 2017, NOLs can no longer be carried back five years (for farmers) or two years (for nonfarmers). This provision has an immediate effect on any farm corporation that has a fiscal year ending in 2018 insomuch as the corporation is not allowed to carry back an NOL for five years. Instead, the NOL for farmers can only be carried back **two years.** All other corporate taxpayers can only carry an NOL forward.[9]

Note. Pre-2018 NOL carryovers are grandfathered such that they can offset 100% of taxable income.

Guidance needed. At the time this chapter was published, it was uncertain whether the definition of "taxable income" for purposes of the NOL computation is determined before or after any pre-2018 NOL carryovers. More guidance is needed on this issue. In August 2018, members of the Senate Finance Committee asked Treasury and IRS officials for a technical correction to reflect legislative intent regarding the changes in NOL carryback and carryforward rules to be effective for NOLs arising in tax years **beginning after** December 31, 2017.

In the event that regulations or other guidance are issued too late to be included in this workbook, coverage will be provided in the form of a supplement, which can be downloaded at **uofi.tax/supplement.**

Example 3. Bill is single and operates a farm in South Dakota. In 2018, Bill's farming operation experienced a $750,000 loss from the farming activity and from the sale of farm equipment. Bill can carry back $250,000 of the loss to 2016 under the 2-year carryback provision. The remaining $500,000 loss carries forward to 2019. If, in 2019, Bill has $450,000 of taxable income from his farming activity, he can offset the $450,000 of income with $360,000 (80% × $450,000) of the loss carryover. Thus, Bill will have $90,000 of income subject to tax in 2019. The remaining $140,000 of unused loss ($500,000 – $360,000) carries forward to 2020.

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6. IRC §461(l).

7. For tax years beginning before 2018, farm losses and NOLs were unlimited unless the farmer received a loan from the Commodity Credit Corporation. In that case, farm losses were limited to the greater of $300,000 or net profits over the immediately preceding five years with any excess losses carried forward to the next year on Schedule F (or related form).

8. IRC §172(b)(2).

9. IRC §§172(b)(1)(A) and (B).

CASH ACCOUNTING METHOD[10]

Effective for tax years ending after December 31, 2017, the cash accounting method is allowable for taxpayers with average annual gross receipts that do not exceed $25 million for the three prior taxable year periods (the "$25 million gross receipts test"). **This provision is permanent.** The $25 million amount is indexed for inflation for tax years beginning after 2018.

A TCJA provision expands the availability of the cash method for farming C corporations (and farming partnerships with a C corporation partner) to include any farming C corporation (or farming partnership with a C corporation partner) that meets the $25 million gross receipts test.

The provision retains the exceptions from the required use of the accrual method for qualified personal service corporations and taxpayers other than C corporations. Thus, qualified personal service corporations, partnerships without C corporation partners, S corporations, and other pass-through entities are allowed to use the cash method without regard to whether they meet the $25 million gross receipts test, as long as the use of the cash method clearly reflects income. In addition, the provision also exempts certain taxpayers from the requirement to keep inventories. In the case of a sole proprietorship, the $25 million gross receipts test is applied as if the sole proprietorship is a corporation or partnership.

BUSINESS INTEREST[11]

For tax years beginning after 2017, deductible business interest is limited to business interest income for the tax year plus 30% of the taxpayer's adjusted taxable income for the tax year that is not less than zero. **Business interest income** is defined as the amount of interest that is included in the taxpayer's gross income for the tax year that is properly allocable to a trade or business. It does not include investment income within the meaning of IRC §163(d). **Adjusted taxable income** is defined as the taxpayer's taxable income computed without regard to the following.

- Any item of income, gain, deduction, or loss that is not properly allocable to a trade or business
- Any business interest expense or business interest income
- Any NOL deduction
- Any IRC §199A deduction
- For tax years beginning before 2022, any deduction allowable for depreciation, amortization, or depletion

Any disallowed amount is treated as paid or accrued in the succeeding tax year. However, businesses entitled to use cash accounting (i.e., average gross receipts do not exceed $25 million for the three prior tax years) are not subject to the limitation. Thus, if average gross revenues are $25 million or less, there is no change in the rules concerning the deductibility of interest.

An electing farm business (as defined by IRC §263A(e)(4)) that is barred from using cash accounting can elect to not be subject to the limitation on the deductibility of interest. In return, such farm business (not including cash rent landlords) must use alternative depreciation on farm property with a recovery period of 10 years or more. However, the election out results in the inability to take bonus depreciation on otherwise eligible assets (in accordance with IRC §263A).

10. TCJA §13102, modifying IRC §448(c).

11. TCJA §13301, modifying IRC §163(j). For a partnership, the business interest limitation applies at the partnership level. Any business interest deductions are considered in determining the partnership's nonseparately stated taxable income or loss. Each partner's adjusted taxable income is determined without regard to the partner's distributive share of any of the partnership's items of income, gain, deduction, or loss.

BUSINESS-PROVIDED MEALS

Beginning in 2018, the current 100% deduction for amounts incurred and paid for the provision of food and beverages associated with operating a business **drops to 50%.**[12] The provision applies to amounts incurred and paid after December 31, 2017, and on or before December 31, 2025, that are associated with providing food and beverages to employees through an eating facility that meets requirements for de minimis fringe benefits and is for the convenience of the employer. After 2025, the allowable amount will be zero.[13] Thus, the provision allowing a deduction for meals provided to employees for the convenience of the employer is **repealed** for amounts paid or incurred **after 2025.**

PARTNERSHIP LOSSES

When determining a partner's distributive share of any partnership loss, the partner takes into account the distributive share of the partnership's charitable contributions and taxes, except that if the fair market value (FMV) of a charitable contribution exceeds the contributed property's adjusted basis, the partner does not take into account the partner's distributive share of the excess.[14] The result of this provision is that basis is not decreased by the excess of the FMV over basis. The provision applies to partnership tax years beginning after 2017.

COST-RECOVERY PROVISIONS

> **Note.** This section discusses the impact of the TCJA cost-recovery provisions on farm taxpayers. Many states may not "couple" on some or all of the provisions mentioned.

Farm Property

New Assets. The TCJA shortens the depreciable recovery period from seven to five years for any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) used in a farming business. The original use must commence with the taxpayer and it must be placed in service after December 31, 2017.[15]

Repeal of 150% Method.[16] Effective for tax years ending after December 31, 2017, the TCJA repeals the required use of the 150% declining-balance method for property used in a farming business (i.e., for 3-, 5-, 7-, and 10-year property). The 150% declining-balance method continues to apply to any 15-year or 20-year property used in the farming business to which the straight-line method does not apply, or to property for which the taxpayer elects the use of the 150% declining-balance method.

> **Note.** For depreciation purposes, the term "farming business" means a farming business as defined in IRC §263A(e)(4).

Expense Method Depreciation.[17] The maximum amount a taxpayer may expense under IRC §179 is increased to $1 million and the phaseout threshold amount is increased to $2.5 million for tax years beginning after 2017. The $1 million and $2.5 million amounts will be indexed for inflation for tax years beginning after 2018. Further, some additional types of property (e.g., roofs and heating, ventilation, and air conditioning systems) qualify for §179 expensing.

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12. TCJA §13304, modifying IRC §274(n).
13. TCJA §13304, modifying IRC §274(o).
14. TCJA §13503, modifying IRC §704(d).
15. TCJA §13203, modifying IRC §168(e)(3)(b).
16. TCJA §13203, modifying IRC §168(b)(2).
17. IRC §179.

Bonus Depreciation. The TCJA allows for 100% first-year bonus depreciation under IRC §168(k) for property acquired by the taxpayer and placed in service after September 27, 2017, through December 31, 2022.[18] A transition rule provides that, for a taxpayer's first taxable year ending after September 27, 2017, the taxpayer may elect to apply a 50% allowance instead of the 100% allowance.[19]

After 2022, the provision is phased out by 20% every year thereafter, with a complete phaseout for property placed in service beginning in 2027. The same rules apply to specified plants bearing fruits and nuts that are planted or grafted after the applicable dates.

Under the TCJA, it is no longer required that the original use of the qualified property commence with the taxpayer. Consequently, bonus depreciation applies to new and used property.

Recent guidance provides further insight into the application of bonus depreciation.[20]

The acquisition of used property must meet the following requirements.

1. The property was not used by the taxpayer or a predecessor at any time prior to the acquisition.
2. The acquisition meets the related party and carryover basis requirements.
3. The acquisition meets the cost requirements.

In the case of a series of related transactions, the transfer of the property is treated as directly transferred from the original transferor to the ultimate transferee and the relationship between the transferring parties is tested after the last transaction in the series.

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Basis adjustments under IRC §734(b) are not considered to be property originally used by the taxpayer because they fail the original use clause in IRC §168(k)(2)(A)(ii) and also fail the used property requirement in §168(k)(2)(E)(ii)(I). Therefore, under the proposed regulations, §734(b) basis adjustments are not eligible for bonus depreciation.[21] Basis adjustments under **IRC §743(b)** fail the original use clause but may satisfy the used property acquisition requirements and be eligible for bonus depreciation.[22]

> **Observation.** As noted earlier, the TCJA changes the rules associated with NOLs in a manner that suggests an NOL should be avoided, if possible, in most situations. A tax strategy to accomplish that goal may be to elect out of 100% bonus depreciation on some or all assets and then claim §179 expensing to reduce income to the desired amount (e.g., in an amount that fully absorbs the 12% rate bracket).

Under an ordering rule, §179 expensing is taken first on an asset, then bonus depreciation, then regular depreciation.[23] However, a taxpayer can elect out of bonus depreciation. Doing so allows the taxpayer to elect the optimal amount of §179 expense. The election out of bonus depreciation applies to all assets in a particular class life (e.g., all new farm equipment has a 5-year class life and all used farm equipment has a 7-year class life). Thus, a taxpayer could, for example, elect out of bonus depreciation with respect to new farm equipment but not with respect to used farm equipment.

18. IRC §168(k)(6)(A).
19. IRC §168(k)(10).
20. REG-104397-18.
21. Prop. Treas. Reg. §1.168(k)-2(b)(3)(iv)(C).
22. Prop. Treas. Reg. §1.168(k)-2(b)(3)(iv)(D).
23. Treas. Reg. §1.179-2(5)(i).

Example 4. Sam and Sue Flay, a married couple, conduct a Schedule F farming operation. Before depreciation, their Schedule F income for 2018 is $300,000. Their plan is to report Schedule F income of approximately $77,400 to fill the 12% income tax bracket.[24]

In May 2018, they purchased new farm equipment for $400,000. Bonus depreciation at 100% on the equipment would result in a $100,000 farm loss for 2018. Therefore, Sam and Sue elect out of bonus depreciation on the equipment and instead claim §179 expense of $200,000. This reduces the Schedule F income to $100,000. Regular depreciation (5-year straight line) of $20,000 is then claimed on the remaining $200,000 of cost to reduce their Schedule F income to $80,000. The remaining cost of $180,000 is depreciated over the next five years.[25]

Plants. For tax years beginning before January 1, 2016, taxpayers with vineyards, orchards, and plants with a preproductive period of more than two years were required to capitalize all of the costs related to the plants until the crop reached "commercial production" (typically 3–5 years).[26] Capitalized costs included direct costs of production and all indirect costs associated with the crops' planting (including capitalizing depreciation on the equipment used during the preproductive period). Once the plant reached commercial production, the taxpayer could depreciate costs related to the plant over 10 years or claim §179 expense or first-year bonus depreciation against the costs. Alternatively, the taxpayer could elect to expense all of the costs. If all costs were expensed, the taxpayer was required to use the alternative depreciation system (ADS) and could not claim bonus depreciation on any farm assets.[27]

Legislation enacted in 2015 provided for an election allowing first-year bonus depreciation for certain plants equal to 50% of their cost (for 2016) that are planted or grafted after 2015.[28] That provision provided for an election that allows first-year bonus depreciation for certain plants equal to 50% of their cost (for 2016) that are planted or grafted after 2015. Under the provision, a "specified plant" is any tree or vine that bears fruit or nuts. It also includes any other plant that will have more than a single yield of fruits or nuts, and that generally has a preproductive period of more than two years from the time of planting or grafting to the time at which the plant begins bearing fruits or nuts.[29]

Observation. The definition of "specified plant" raises a question as to whether it includes the plant plus all IRC §263A preproductive costs incurred for the year of planting. If it does, then the amount that is available for bonus depreciation in the year of planting includes those costs. On the other hand, if that definition only includes the cost of the plant, then preproductive costs that are associated with developing the plant might not be included.

24. See IRC §1(j)(2)(A).

25. The remaining cost will actually be depreciated over six years rather than five years because ½ year of deprecation is taken in the first year and ½ year of depreciation is taken in the sixth year.

26. Treas. Reg. §1.263A-4.

27. See, generally, IRC §263A.

28. TCJA §13201, modifying IRC §168(k)(5); *Joint Explanatory Statement of the Committee of Conference.* [docs.house.gov/billsthisweek/20171218/Joint%20Explanatory%20Statement.pdf] Accessed on Jun. 26, 2018.

29. IRC §168(k)(5).

Bonus Depreciation. Under the TCJA, the applicable percentage for bonus depreciation is 100% for property placed in service after September 27, 2017, and before January 1, 2023.[30] In addition, if a farmer has gross receipts of $25 million or less, they can expense all direct and indirect costs associated with plantings, including the cost of the plants.[31]

> **Note.** For a taxpayer that previously chose to capitalize the direct and indirect costs but not to have bonus depreciation available on any farm assets, it is uncertain whether the taxpayer can now elect back into the depreciation system. If the taxpayer can elect back into the system (and their revenues are $25 million or less), the taxpayer could deduct all of the costs immediately. If an election back in is not possible, capitalization of the direct and indirect costs is required and bonus depreciation cannot be claimed. This is the result even if no orchards or vineyards were planted in recent years.

Example 5. Michael is a farmer in Missouri. He planted an orchard in 2011. His average gross receipts do not exceed $25 million. He elected to expense the direct and indirect costs of the orchard, which barred him from claiming bonus depreciation on any farm assets. In 2018, Michael purchased new farm equipment costing $1.75 million. If Michael **cannot elect** back into the prior depreciation system, he cannot claim bonus depreciation on the new farm equipment. However, he could claim §179 expensing and regular MACRS depreciation.

Alternatively, if Michael **can elect** back into the prior system, then the entire $1.75 million of new asset purchases qualifies for 100% bonus depreciation.

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> **Note.** In Rev. Proc. 2018-35, the IRS provided a new automatic change for taxpayers to change their method of accounting from applying IRC §263A to citrus plant replanting costs to not applying IRC §263A to those costs after a loss.

LIKE-KIND EXCHANGES

For exchanges completed after 2017, the TCJA modifies IRC §1031, which provides for nonrecognition of gain in the case of like-kind exchanges, by limiting its application to **real property** that is not held primarily for sale. Like-kind exchange treatment of personal property is no longer allowed.

Example 6. In 2017, Frank Farmer traded in his old tractor, worth $150,000, for a new tractor worth $400,000. The old tractor had a zero basis. The $150,000 trade value is essentially ignored and the tax basis of the new tractor is $250,000 (the net cash paid).

Example 7. Use the same facts as **Example 6,** except Frank traded in his tractor in 2018. He must recognize a gain on the old tractor of $150,000, reported on Form 4797. Frank's income tax basis in the new tractor is $400,000, on which Frank claims 100% bonus depreciation as a deduction on Schedule F. The gain on the trade is not subject to SE tax.

> **Observation.** Through 2022, the new rule eliminating like-kind exchange treatment on personal property trades triggers less federal tax than under prior law if the taxpayer takes 100% bonus depreciation.

30. IRC §168(k)(6)(A).

31. TCJA §13102, modifying IRC §§263A, 448, and 471.

Many states that have a state income tax disallow or limit the amount of §179 expensing or bonus depreciation. In these states, additional tax compared to pre-TCJA law will be triggered.

Example 8. Use the same facts as **Example 7,** except at the time of the trade Frank had already claimed $200,000 of depreciation for state tax purposes on the old tractor and had an adjusted cost basis in the tractor of $200,000. Thus, the selling price of $150,000 produced a tax loss on the state tax return of $50,000. If Frank's state conforms to the federal provision applicable to new farm personal property (5 years; 200% declining balance) but does not allow bonus depreciation or §179 expensing, he can only deduct depreciation of $80,000 on the new tractor.

At the federal level, Frank had a gain of $150,000 and a deduction for bonus depreciation of $400,000 on the new tractor, for a net taxable income reduction of $250,000. At the state level, Frank reports a $50,000 loss and deducts depreciation of $80,000, for a net deduction of $130,000.

Note. For additional information on like-kind exchanges, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues.

NEW IRC §199A: THE QUALIFIED BUSINESS INCOME DEDUCTION

Note. For additional information on the qualified business income deduction (QBID), see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: New Legislation — Business Concerns, and Chapter 2: Small Business Issues.

FORMER IRC §199

For tax years beginning after 2004, a taxpayer could claim a domestic production activities deduction (DPAD) for a portion of the taxpayer's qualified production activities income (QPAI). For tax years beginning after 2009, the DPAD was 9% for all taxpayers except those involved in oil and gas production. For oil and gas businesses, the DPAD was 6%. However, the DPAD was limited to the lesser of 9% of QPAI or 50% of the wage expense allocated to manufacturing, producing, growing, and extracting activities.

DPAD Application to Cooperatives

Agricultural and horticultural cooperatives could also claim the DPAD and allocate any portion of it to the cooperative's patrons. Any amount allocated to a patron was not subject to a wage limitation in the patron's hands.[32]

Note. The proposed regulations issued August 8, 2018, did not address the application of QBID to cooperatives. Further guidance is needed.

In the event that regulations or other guidance are issued too late to be included in this workbook, coverage will be provided in the form of a supplement, which can be downloaded at **uofi.tax/supplement.**

32. IRC §199(d)(3).

Under the TCJA, the DPAD was repealed for tax years beginning after 2017. A transition rule applies such that the repeal does not apply to a qualified payment that a patron receives from an agricultural cooperative in a tax year beginning after 2017. This applies to the extent that the payment is attributable to QPAI with respect to which the DPAD was allowed to the cooperative for the cooperative's tax year that began before 2018.[33] Such qualified payments are subject to the pre-2018 DPAD provision. Any deduction allocated by a cooperative to patrons related to that type of payment can be deducted by patrons in accordance with the pre-2018 DPAD rules. In that event, no post-2017 qualified business income deduction (QBID) is allowed for these qualified payments.

Observation. In late December 2017, many cooperatives allocated an additional DPAD to patrons as a result of the TCJA. The transition rule was not enacted until March 22, 2018. Ultimately, whether the additional DPAD passed through from a cooperative in late 2017 is a benefit to patrons depends on the patron's tax rates for 2017 and 2018.

Example 9. Acme Grain Cooperative allocated an additional $10,000 of DPAD to Rusty Runner in late December 2017 that was associated with 2016 patronage. Acme also allocated an additional $20,000 of DPAD to Rusty in late December 2017 that was for 2017 patronage. Acme issued Rusty a Form 1099-PATR, *Taxable Distributions Received From Cooperatives.* Those allocations are deductible by Rusty at the applicable 2017 tax rates. If he had received the allocations in 2018, they would have been deducted at the 2018 rates, which may be lower.

QUALIFIED BUSINESS INCOME DEDUCTION

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For tax years beginning after 2017 and before 2026, a noncorporate business owner as well as an owner of an interest in a pass-through entity is entitled to a deduction of 20% of the taxpayer's share of qualified business income (QBI) associated with the conduct of a trade or business in the United States.[34] The QBID replaces the DPAD, which applied for tax years beginning after 2004. The TCJA repealed the DPAD for tax years beginning after 2017.

The QBID is allowed only for income tax purposes and is allowed against alternative minimum tax (AMT), with no separate computation required.[35] It is not allowed for purposes of SE tax or the net investment income tax (NIIT), or for determining any NOL.[36]

The QBID is subtracted from taxable income but does not affect the calculation of adjusted gross income (AGI).[37] This is an important point for farmers participating in federal farm programs. For federal farm program eligibility purposes under the 2014 Farm Bill rules, an AGI limit applies.[38] The limit is $900,000 and is determined by using the AGI amount from Form 1040. For tax years beginning before 2018, the AGI computation included the DPAD. However, for tax years beginning after 2017, the AGI computation does not include the QBID. This change could result in unexpected ineligibility for payment limits ($125,000 per "person"). Of course, the tradeoff for being ineligible for payment limits could be a larger QBID.

Because the QBID is an adjustment to taxable income, it is also available to taxpayers who do not itemize deductions.[39]

Note. The QBID is not affected by whether the taxpayer is materially involved in the business activity. The taxpayer's percentage ownership is relevant. QBI is dependent on whether the taxpayer has ordinary income (tentative taxable income less qualified dividends and net long-term capital gain).[40]

33. PL 115-141, Div. T, §101(c), amending PL No. 115-97, §13305(c), enacted into law on Mar. 22, 2018.

34. IRC §§199A(a) and 199A(c)(3)(A)(i). QBI does not include income from a specified service business. IRC §199A(d)(2).

35. IRC §§199A(f)(2)–(3).

36. IRC §172(d)(8).

37. See IRC §62(a), flush language. Thus, the various phase-ins and phaseouts which are based on AGI are not impacted by IRC §199A.

38. *Adjusted Gross Income.* USDA. [www.fsa.usda.gov/programs-and-services/payment-eligibility/adjusted-gross-income/index] Accessed on Aug. 15, 2018.

39. IRC §63(b)(3).

40. IRC §199A(a)(2).

Included and Excluded Income Items

QBI **includes** net amounts of income, gain, deduction, and loss with respect to any qualified trade or business.[41] However, QBI **does not include** reasonable compensation paid to an S corporation shareholder and guaranteed payments paid to a partner, or any payment paid to a partner for services rendered with respect to the trade or business of the partnership.[42]

> **Note.** The QBID for a sole proprietor does not take into account any substitute for a reasonable wage. Thus, the entire net profit reported on the Schedule F (or Schedule C) is considered QBI for purposes of the deduction.

Example 10. Julie is a Kansas farmer who anticipates generating $150,000 of net income in 2018. Her QBID varies depending on the business structure of her farming activity, provided no limiting factors (explained later) apply to her situation.

Sole Proprietorship:	
Net income/initial QBI	$150,000
Less: 50% of SE tax [a]	(9,970)
Net QBI	$140,030
QBI rate	× 20%
Initial QBID for sole proprietorship	$ 28,006
S Corporation:	
Net income	$150,000
Less: Julie's W-2 wages	(55,000)
Less: 50% of FICA tax [b]	(4,208)
Net QBI	$ 90,792
QBI rate	× 20%
Initial QBID for S corporation	$ 18,158

[a] ((($150,000 × 92.35%) × 2.9%) + $15,922) × 50% = $9,970

[b] $55,000 × 7.65% = $4,208

> **Note.** For a detailed comparison of the effect of various entity forms on the QBID calculation, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Entity Comparison.

Proposed regulations clarify that the following are **not** taken into account for purposes of computing QBI of the recipient partner.[43]

- Guaranteed payments for the use of capital
- Guaranteed payments described in IRC §707(c) for services rendered to the trade or business
- Payments described in IRC §707(a) for services rendered to the trade or business

However, the partnership's deduction for each item is taken into account for computing QBI of the partnership.

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41. IRC §199A(c). QBI does not include qualified REIT dividends and qualified publicly traded partnership income. IRC §199A(c)(1). However, they are provided separate treatment as part of the QBID. Thus, income from these sources is not part of the QBI on which the 20% deduction is determined. They generate a separate 20% deduction that is not subject to other limitations. The QBI amount from REITs and publicly traded partnerships is combined with other QBI amounts for purposes of the overall limitation.

42. IRC §199A(c)(4).

43. REG 107892-18; Prop. Treas. Reg. §1.199A-3.

QBI also **does not include** any of the following.[44]

- Capital gain
- Dividends (or their equivalent, or payment in lieu of a dividend)
- Interest income unless it is allocable to the taxpayer's trade or business[45]
- Any amount received from an annuity that is not in connection with a trade or business
- Certain commodity transactions
- Foreign currency gains or losses
- Speculative gains

Example 11. Porky operates a hog farming business and hedges his feed costs in corn and soybeans. In 2018, Porky had hedging gains of $80,000. Porky recognized a gain on wheat futures of $30,000. Porky's initial QBID is increased by $16,000 ($80,000 × 20%) for the hedging gain. The gain associated with the wheat futures is speculative gain and does not increase Porky's final QBID.

Observation. A guaranteed payment can create a partnership loss. That should be distinguished from a preferred allocation of income, which is determined after calculating the results of partnership operations.

Example 12. John and Jessica conduct a farming operation as a general partnership. During 2018, the partnership generated $100,000 of farm income. John received a guaranteed payment of $110,000 and, as a result, the partnership reported a loss of $10,000. The $10,000 loss is negative QBI. However, if John was specially allocated the first $100,000 of income and then John and Jessica evenly split all partnership income thereafter (if any), all the farm income is considered QBI.

As indicated earlier, QBI includes net amounts of income, gain, deduction, and loss with respect to any qualified trade or business. Business-related items that constitute QBI include any of the following.[46]

- Ordinary gains and losses from Form 4797
- Deductions for state income tax on the taxpayer's trade and business income[47]
- Deductions that are attributable to a business that is carried on in an earlier year[48]
- Deduction for self-employed health insurance[49]
- The deductible portion of SE tax[50]

44. IRC §199A(c)(3).

45. For purposes of §199A, interest income from working capital reserves is not allocable to a trade or business; Prop. Treas. Reg. §1.199A-3(b)(2)(ii)(c).

46. The NOL definition under IRC §172 provides guidance on what constitutes "business-related items."

47. See Rev. Rul. 70-40, 1970-1 CB 50.

48. *Penton v. U.S.,* 259 F.2d 536 (6th Cir. 1958).

49. IRC §162(l).

50. IRC §164(f)(2); see also IRS Form 1045, Schedule A instructions.

Note. Nonbusiness deductions include IRA deductions and deductions for contributions to a health savings account.[51] Alimony is also nonbusiness income (or deduction).[52] While an ordinary loss on the sale or exchange of stock in a small business corporation is treated (for NOL purposes) as being attributable to the taxpayer's trade or business, nonbusiness items (for NOL purposes) include ordinary losses on the sale or exchange of stock in a small business corporation,[53] and retirement plan contributions for a sole proprietor or partner.[54] Guidance is needed concerning whether these items constitute business income for QBI purposes.

Treatment of Capital Gain or Loss

By statute, capital gain or loss is not QBI.[55] The deduction is limited to 20% of taxable income less capital gains (including IRC §1231 gains such as those generated by the sale of culled breeding stock). Thus, if the only source of taxable income on a taxpayer's return is derived from capital gain (including qualified dividends), the taxpayer has no QBI.

Example 13. John and Mary (a married couple) operate a cow/calf operation. During 2018, they sell raised breeding stock that was held for more than two years for a $300,000 capital gain. Their ordinary income for the tax year is zero and they net $300,000 of taxable income. The initial QBID is limited to 20% of taxable income ($300,000) less capital gains ($300,000). Thus, the final QBID for John and Mary is zero.

Example 14. Use the same facts as **Example 13,** except John and Mary sell breeding stock that was purchased eight years ago for $200,000 and has been fully depreciated. Their breeding stock sale generates $200,000 ordinary gain from depreciation recapture and $100,000 capital gain. Their net QBI is $200,000 ($300,000 taxable income – $100,000 capital gain) and their initial QBID is $40,000 ($200,000 × 20%).[56]

Observation. Raised breeding stock does not produce a QBID benefit under IRC §199A. This is a significant difference from the DPAD benefit under the former IRC §199 rules.

Rental Income

Whether rental income is QBI depends on whether the rental activity by the taxpayer rises to the level of a trade or business. However, as mentioned earlier, §199A does not require the taxpayer to materially or significantly participate in the trade or business. The proposed regulations define a trade or business as an IRC §162 trade or business other than the performance of services as an employee. Rental of tangible or intangible property not rising to that level is nevertheless treated as a trade or business for purposes of §199A[57] if the property is rented to a commonly controlled trade or business.[58]

Note. Further guidance is needed for rentals that do not meet the common control tests (unrelated parties). If the standard is not material participation but rather continuity and regularity, the facts and circumstances of each situation must be evaluated. It could be possible that some cash rent or crop share arrangements meet the requirements to be QBI and others may not.

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51. See the instructions to IRS Form 1045, page 6.

52. See, e.g., *Monfore v. Comm'r,* TC Memo 1988-197 (May 4, 1988).

53. IRC §1244(d)(3).

54. IRC §172(d)(4)(D).

55. IRC §199A(c)(3)(B)(i).

56. REG 107892-18, Preamble III(vii)(a).

57. Prop. Treas. Reg. §1.199A-1(b)(13).

58. Prop. Treas. Reg. §1.199A-4(b)(1)(i).

Aggregation[59]

The proposed regulations identify the requirements to aggregate businesses for QBID purposes, specifically for purposes of the wages and qualified property (QP) limitations (explained later). This grouping is separate and distinct from other grouping purposes. Rental income can be grouped with trade and business income, and grouping allows wages and QP to be aggregated into one amount for computing QBID.

To be eligible for aggregation, **all** of the following criteria must be met.

- The same person or group of persons directly or indirectly owns 50% or more of each business to be aggregated.
- The ownership exists for more than half of the tax year.
- All items for each business are reported on returns with the same tax year.
- None of the businesses is a specified service trade or business.
- At least two of the following factors are satisfied.
  - Provide products and services that are the same or offered together
  - Share facilities or significant business elements
  - Operated in coordination with or reliance upon one or more of the group

Negative QBI

QBI of a particular business may be negative (a qualified business loss (QBL)) even if the taxpayer has an overall positive separate QBI.[60] If a taxpayer's net QBI is a loss, the QBL carries over to the following year and is treated as a loss from a trade or business in that succeeding year.[61] If the taxpayer's return reports income from one of its business activities but the overall business activities produce a net loss, the taxpayer is not entitled to a QBID.[62] The QBID cannot be less than zero.

> **Example 15.** Shorty operates a small animal feed manufacturing business, which he operates as a sole proprietorship. He also has a Schedule F farming operation. For 2018, the manufacturing business produces net income of $50,000. Shorty's farming operation generates a loss of $75,000. Because Shorty's net business income is a loss, he has a QBL of $25,000. The QBL of $25,000 carries forward to 2019 as negative QBI of a separate trade or business. In 2019, Shorty will need positive QBI of at least $25,000 before his QBI will exceed zero.

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59. Prop. Treas. Reg. §1.199A-4.

60. See Example 2, page 37, of the *Joint Explanatory Statement of the Committee of Conference.* [docs.house.gov/billsthisweek/20171218/Joint%20Explanatory%20Statement.pdf] Accessed on Jun. 26, 2018.

61. IRC §199A(c)(2). The effect, therefore, of the net loss is to reduce the next year's QBID.

62. If the taxpayer has multiple businesses, the income **from all of the businesses** is netted to determine if QBI is positive for the tax year.

QBID CALCULATIONS

Initial, Reduced, and Final QBID

The taxpayer determines the QBI amount from each qualified trade or business.[63] Combined, this equals the **total amount of qualified business income that is eligible for the 20% deduction.** Thus, the initial QBID is 20% of the QBI determined for each of the taxpayer's separate trades or businesses.[64] For taxpayers whose income exceeds the threshold amount (discussed later), the initial QBID for each of the taxpayer's trades or businesses is the **lesser** of 20% of QBI, or the **greater** of the following (referred to as the W-2 wages/QP limit).

- 50% of the taxpayer's share of allocable **W-2 wages** of the qualified businesses (defined later)
- 25% of the taxpayer's share of allocable **W-2 wages** of the qualified business, **plus** 2.5% of the unadjusted basis, immediately after the acquisition, of all **QP** (defined later)

Example 16. Joel is a single farmer with net 2018 farm income of $250,000. He paid wages of $50,000 and has $600,000 of QP. Joel's QBID is calculated as follows.[65]

The **lesser** of:

- Initial QBID of $50,000 ($250,000 × 20%), **or**
- The **W-2 wages/QP limit,** which is the **greater** of:
  - W-2 wages limit: $50,000 × 50% (W-2 wages) = $25,000
  - QP limit: $50,000 × 25% (W-2 wages) + $600,000 × 2.5% (QP) = **$27,500**

Therefore, Joel's final QBID is **$27,500.**

Example 17. Use the same facts **as Example 16,** except Joel also had another business activity that had a loss for the year. Joel custom cuts crops for other farmers, and that business lost $150,000 in 2018. In addition, Joel had $200,000 of nonbusiness income. Joel's final QBID is calculated as follows.

The **least** of:

- Initial QBID of **$20,000** (($250,000 farm income – $150,000 custom cuts loss) × 20%),
- W-2 wages/QP limit: $27,500 (calculated in **Example 16**), **or**
- OTI limit (defined later): $60,000 ($300,000 overall income × 20%)

Therefore, Joel's final QBID is **$20,000.**

W-2 Wages/QP Limit

The W-2 wages/QP limit **does not apply** to a taxpayer with taxable income (computed before the QBID) that is at or below the threshold amount of $315,000 (MFJ) or $157,500 (other taxpayers).[66] Therefore, taxpayers with taxable income equal to or less than the applicable threshold do not need to compute the W-2 wage/QP limit.[67] These taxpayers net all qualified trade or business income from all activities and multiply the result by 20% to arrive at their combined QBID, but this is limited to 20% of their **overall taxable income** (referred to as the **OTI limit).**

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63. IRC §199A(b)(1). The Code does not provide any guidance on how to distinguish one business from another. However, Treas. Regs. §§1.461-4(d)(5)(ii) and 1.446-1(d)(2) do provide some guidance.
64. IRC §199A(b)(2)(A).
65. IRC §199A(b)(2).
66. IRC §§199A(b)(3)(A) and (e)(2)(A).
67. IRC §§199A(b)(2), (b)(3), and (e)(2).

For taxpayers with taxable income above the threshold amounts, the W-2 wages/QP limit phases in over a range of \$100,000 (MFJ) or \$50,000 (other taxpayers).[68] This calculation adjusts the initial QBID to arrive at the final QBID for each business of the taxpayer. The amount of the adjustment depends upon the level of the taxpayer's initial QBID relative to the threshold amount. IRC §199A(b)(3)(B) prescribes the manner of the reduction as follows.

1. Determine the taxpayer's initial QBID (net taxable income × 20%).
2. Determine the reduced QBID as if the W-2 wages/QP limit fully applies.
3. Determine the taxpayer's tentative taxable income less their applicable threshold amount (\$315,000 MFJ, \$157,500 other taxpayers).
4. Determine the applicable percentage by dividing the result of Step 3 by the applicable phasein range (\$100,000 MFJ, \$50,000 other taxpayers) to arrive at a percentage.
5. Multiply the applicable percentage calculated in Step 4 by the amount of the reduction due to the W-2 wages/QP limit determined in Step 2.
6. Subtract the amount determined in Step 5 from the initial QBID determined in Step 1.

The following example illustrates the effect of paying wages and/or having QP when the W-2 wages/QP limit applies.

Example 18. Ted is a single farmer who farms via his S corporation. In 2018, Ted has \$300,000 of net farm income (all QBI). During 2018, he pays \$40,000 of qualifying W-2 wages and has \$500,000 of QP. Ted's taxable income is \$200,000 before taking into account the QBID. This income exceeds the \$157,500 threshold for single filers. He calculates his \$28,125 final QBID using the following steps.

1. Initial QBID = \$60,000 (\$300,000 net farm income × 20%)
2. W-2 wages/QP limit is **greater** of:
    a. W-2 wage limit: \$40,000 × 50% = \$20,000
    b. QP limit: (\$40,000 wages × 25%) + (\$500,000 QP × 2.5%) = **\$22,500**

    The adjusted initial QBID is \$37,500 (\$60,000 initial QBID – \$22,500 W-2 wages/QP limit)
3. Tentative taxable income less threshold amount = \$42,500 (\$200,000 – \$157,500)
4. Applicable percentage = 85% (\$42,500 ÷ \$50,000)
5. Applicable percentage multiplied by the reduced QBID = \$31,875 (\$37,500 × 85%)
6. Step 1 amount minus Step 5 amount = \$28,125 (\$60,000 – \$31,875)

Now assume that Ted pays no qualifying wages and has no QP. His QBID is \$9,000, calculated as follows.

1. Initial QBID = \$60,000 (\$300,000 net farm income × 20%)
2. W-2 wages/QP limit is **greater** of:
    a. W-2 wage limit: \$0 × 50% = \$0
    b. QP limit: (\$0 wages × 25%) + (\$0 QP × 2.5%) = \$0

    There is no adjustment to the QBID. Therefore, the reduced QBID is \$60,000.
3. Tentative taxable income less threshold amount = \$42,500 (\$200,000 – \$157,500)

68. IRC §199A(b)(3)(B)(i)(I).

4. Applicable percentage = 85% ($42,500 ÷ $50,000)
5. Applicable percentage multiplied by the reduced QBID = $51,000 ($60,000 × 85%)
6. Step 1 amount minus Step 5 amount = $9,000 ($60,000 – $51,000)

Observation. Taxpayers with income over $207,500 (or $415,000 for MFJ taxpayers) are fully subject to the W-2 wages/QP limit. If the taxpayer has no W-2 wages or QP, then the taxpayer is ineligible for the QBID.

Note. Excess wages and investments from one business cannot be used in the calculation of the QBID for another business.[69] Each business stands on its own, unless the aggregation election is made.

Qualified Wages

Qualified wages for purposes of the QBID are W-2 wages that are allocable to the business's QBI[70] and that are subject to payroll taxes paid by the taxpayer with respect to employment of employees during the calendar year ending during the taxpayer's tax year.[71] Therefore, wages paid in commodities are not included for this purpose.[72] However, wages paid to children under age 18 by the parents are qualified wages even though they are not subject to payroll tax.

W-2 Wages Defined. IRC §199A(b)(4)(A) references IRC §6051(a) for the definition of W-2 wages. In particular, IRC §6051(a)(3) specifies that the total wages are defined in IRC §3401(a), which is wages for withholding purposes.

The IRC §3401(a) definition comprises all wages, including wages paid in a medium other than cash, except wages paid for agricultural labor unless the wages are for payroll tax purposes under §3401(a)(2). Wages paid to children under age 18 by their parents are not included as an exception in §3401(a). Such wages are subject to withholding but are often exempt because the amount is less than the standard deduction. However, under §3401(a)(2), commodity wages are not included because they are not "wages" under IRC §3121(a).[73] Therefore, wages paid to children under age 18 by their parents count as wages for QBI purposes, but agricultural wages paid in-kind do not.

IRC §199A(b)(4)(A) also references IRC §6051(a)(8) as W-2 wages. That provision adds back elective deferrals to wages and is the identical language contained in former IRC §199(b)(2)(A).

Three methods exist for calculating W-2 wages.[74]

1. Under the **unmodified box method,** the W-2 wages amount equals the lesser of the amounts in box 1 or box 5.
2. Under the **modified box 1 method,** the W-2 wages amount equals the amount reported in box 1 less those amounts in box 1 that are not wages for federal income tax withholding, plus the amounts reported in box 12 coded as D, E, F, G, and S.
3. Under the **tracking wages method,** the W-2 wages amount equals the actual amount of wages subject to federal income tax withholding plus the amount reported in box 12 coded as D, E, F, G, and S.

Observation. Most farmers will prefer the second method because it allows wages for minor children and employee deferrals to increase the amount of computed wages.

69. IRC §199A(b)(2).
70. IRC §199A(b)(4).
71. IRC §199A(b)(4)(A).
72. The same is true for guaranteed payments paid to partners.
73. See IRC §3121(a)(8)(A).
74. IRS Notice 2018-64, 2018-34 IRB.

Increasing the amount of W-2 wages paid can result in a higher QBID and, therefore, a lower tax liability.

Example 19. Nippan-Tuck Farm is an S corporation that generates $350,000 of net farm income in 2018 (all QBI). During 2018, the S corporation pays $45,000 of W-2 wages subject to payroll tax to its owner, Sally. The S corporation has no QP. Sally's taxable income is $450,000 (MFJ).

Sally's initial QBID is $70,000 ($350,000 net farm income × 20%). However, because her taxable income is above the threshold of $315,000 for MFJ, her reduced QBID is limited to 50% of wages, which is **$22,500** (50% × $45,000).

If Sally increases her W-2 wages to $60,000, her additional payroll tax would be $2,295 ($15,000 increased wage amount × 15.3% FICA rate). Her QBID would now be limited to **$30,000** (50% × $60,000).

Because Sally is in the 35% bracket, she saves $2,625 (($30,000 – $22,500) × 35%) of income tax. Her net tax savings would be $330 ($2,625 income tax savings – $2,295 additional payroll tax).

Qualified Property (QP)

QP for purposes of the W-2 wages/QP limit is tangible, depreciable property held by and available for use in a qualified trade or business of the taxpayer as of the close of the tax year.[75] The **unadjusted basis** of QP is multiplied by 2.5% in calculating the W-2 wages/QP limit (as shown earlier). The unadjusted basis of property is used in the calculation until the **later of** the end of the property's recovery period or 10 years.[76]

Example 20. Ronald Chee began farming in 2018. He is single and his 2018 taxable income is $500,000, making him subject to the W-2 wages/QP limit. During 2018, he bought a combine for $300,000, built a machine shed at a cost of $100,000, and paid no wages. His W-2 wages/QP limit is $10,000 ($400,000 QP × 2.5%). The recovery period of the machine shed is 20 years; therefore, it continues to be QP for 20 years. The combine has a recovery period of five years but is considered QP for 10 years.

Farm taxpayers that are subject to the wage limitation or have insufficient wages and/or QP may benefit from making the election to capitalize repairs and de minimis expenditures[77] rather than taking a current deduction for them.

Example 21. Jeannie is an unmarried farmer with net income (QBI) of $160,000 and tentative taxable income of $400,000 for 2018. She pays no wages and has no QP. For 2018, Jeannie incurs repair expenses of $100,000 and de minimis expenditures of $50,000. Her initial QBID is $32,000 ($160,000 net income × 20%), but it is limited to zero because she has no wages and no QP and her tentative taxable income exceeds the $207,500 upper threshold for taxpayers other than MFJ.

However, if Jeannie elects to capitalize repairs and de minimis expenses, her QP amount would be $150,000. She could then make a §179 election for the $150,000. Jeannie would then have a final QBID of $3,750 ($150,000 × 2.5%).

The sale of a farming business can affect QP. Presumably, the QP that is held immediately before the sale is considered in the QP limit. The Treasury is directed to provide guidance for situations in which the taxpayer acquires or disposes of a major portion of a trade or business or the major portion of a separate unit of a trade or business during the tax year.[78] In addition, the timing of the sale may have a significant impact on wages.

75. IRC §199A(b)(6).

76. IRC §199A(b)(6)(B).

77. Treas. Reg. §1.263(a)-3(n)(1).

78. IRC §199A(b)(5).

Property is not QP if the property is acquired within 60 days of the end of the tax year and disposed of within 120 days unless it was used in the trade or business at least 45 days prior to disposition. There is an exception if the principal purpose of the acquisition and disposition was for a purpose other than increasing the QBID.[79]

Example 22. Cheri's farm business reports $200,000 of annual W-2 wages expense and has $1.5 million of QP. Cheri sells her farm on December 31, 2018, for a $3 million gain. Of that $3 million, $1 million is depreciation recapture. During 2018, Cheri's farm operation broke even.

Her initial QBID would have been $600,000 ($3 million × 20%). However, her initial QBID is limited to 20% of taxable income ($3 million) less capital gain ($2 million) or $200,000. The QBID is further limited to the **greater** of 50% of W-2 wages ($100,000) or 25% of W-2 wages plus 2.5% of the unadjusted basis of QP ($87,500). Her final QBID is $100,000 (50% of the $200,000 W-2 wages expense).

If Cheri sold her farm on January 1, 2019, her final QBID might be completely eliminated because she would have no wage expense and no QP. However, if guidance allows QP to be used after disposition, this would result in a final QBID of $37,500 ($1.5 million × 2.5%).

Note. The same issues with wages and QP that are present upon sale of a business early in the tax year can occur when a business is started late in the year. However, when a business is started, the cost of asset acquisitions can be offset (at least in part) by the use of bonus depreciation.

Combined QBID

A taxpayer's combined QBID is the sum of the taxpayer's QBID from each qualified trade or business **plus** 20% of the aggregate qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income for the year.[80]

Under IRC §199A(a), a taxpayer's final QBID is the taxpayer's combined QBID, limited to OTI, which is an amount equal to 20% of the excess of:

- Tentative taxable income, over
- The sum of the net capital gain[81] for the year.

When the net QBI from all qualified businesses is less than zero, the combined QBID from qualified businesses is zero for the tax year. The resulting qualified business loss (QBL) is then treated as negative QBI from a separate trade or business in the taxpayer's succeeding tax year. This requirement does not affect the deductibility of the loss under other sections of the Code.

Taxpayers who have one or more businesses with QBLs but net positive overall QBI must apportion their QBLs among the businesses with positive QBI in proportion to the relative amounts of their positive QBI. The business's QBI less its allocation of losses from other businesses is its **adjusted QBI.**[82]

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79. Prop. Treas. Reg. §1.199A-2(c)(1)(iv).

80. IRC §§199A(b)(1)(A)–(B).

81. Net capital gain is defined in IRC §1(h) and includes qualified dividends under IRC §1(h)(11).

82. Prop. Treas. Reg. §1.199A-1(d)(2)(iii)(A).

Example 23. Dan is a Minnesota farmer. In addition to farming, he operates a custom spraying business and a drainage tile installation business. His businesses have the following income in 2018. Dan must calculate the initial QBI for each business separately, then apportion any losses among the businesses with positive QBI pro rata to determine the adjusted QBI for each business.[83]

Business	QBL	QBI	Adjusted QBI
Custom Spray	($10,000)		
Farm		$200,000	
Less: ⅔ of QBL		(6,667)	
		$193,333	$193,333
Drain Tile		$100,000	
Less: ⅓ of QBL		(3,333)	
		$ 96,667	96,667
Combined QBI			$290,000
			× 20%
Initial QBID			$ 58,000

In 2018, Dan also received REIT dividends and PTP income. Dan's final QBID is $58,800, provided his income does not exceed the applicable threshold.

Qualified REIT Dividend and PTP Income	2018 Income	QBID
REIT dividends	$3,000	
	× 20%	
	$ 600	$ 600
PTP income	$1,000	
	× 20%	
	$ 200	200
Business QBID		58,000
Final QBID		$58,800

Dan would need $294,000 of taxable income to fully utilize the entire deduction ($294,000 income × 20% = $58,800).

A farmer may have substantial combined QBI, but the final QBID cannot exceed 20% of the farmer's net ordinary income. Thus, if tentative taxable income is all long-term capital gain, the taxpayer is not entitled to any QBID.

83. Prop. Treas. Reg. §1.199A-1(d)(2)(iii).

Example 24. Rusty is a dairy farmer, and files a joint tax return with his spouse. In 2018, he has Schedule F income of $140,000, long-term gain from mutual fund investments of $60,000, and $150,000 of income from the sale of purchased dairy cows that are fully depreciated. His tentative taxable income is $350,000. Rusty's final QBID is limited to 20% of ordinary income, or $58,000 (($350,000 taxable income – $60,000 capital gain) × 20%).

Observation. In the example, if Rusty had traded the raised dairy cows for new dairy cows instead of selling them, a better tax result could have been obtained. While a tax-free exchange is no longer available for trades of personal property such as dairy cows, Rusty would have recognized $150,000 of IRC §1231 gain on the "trade" and would have received an income tax basis of $150,000 in the new dairy cows, which Rusty could have offset with $150,000 of bonus depreciation. The ability to claim bonus depreciation reduces Rusty's ordinary income and decreases SE tax.

Note. The example above assumes that the unadjusted income tax basis of replacement property received in a trade for purposes of IRC §199A is the selling price of the property given up in the exchange. IRS guidance is needed to ensure this is correct. The proposed regulations issued in August 2018 do not address this issue.

Cooperative Rule

A special rule applies with respect to farm income received from an agricultural or horticultural cooperative. Under the rule, the combined QBID is reduced by the lesser of 9% of the QBI that is allocable to qualified payments from the cooperative, or 50% of the W-2 wages associated with the QBI from the cooperative.[84] This is explained in more detail later in this section.

COOPERATIVES AND PATRONS OF COOPERATIVES

Cooperatives

Agricultural and horticultural cooperatives[85] are allowed a deduction equal to 9% of the lesser of the cooperative's QPAI [86] for the year or taxable income (determined without regard to patronage dividends, per-unit retain allocations, and non-patronage distributions).[87] The deduction, however, cannot exceed 50% of the cooperative's W-2 wages for the year that are subject to payroll taxes and are allocable to domestic production gross receipts.[88]

Observation. The deduction, for most cooperatives, is limited to 50% of W-2 wages. It is unlikely that a cooperative's wages as a percentage of revenue will exceed 9%.

The cooperative may choose to either claim the deduction or allocate the amount to patrons (including other specified agricultural or horticultural cooperatives or taxpayers other than C corporations).[89]

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84. IRC §199A(b)(7).
85. As defined in IRC §199A(g)(4)(A).
86. As defined in IRC §199A(g)(3).
87. IRC §§199A(g)(1)(A) and (C).
88. IRC §199A(g)(1)(B).
89. IRC §§199A(g)(2)(A) and (D).

Patrons of Cooperatives

An eligible patron of an agricultural or horticultural cooperative that receives a **qualified payment** from the cooperative can claim a deduction in the tax year of receipt in an amount equal to the portion of the cooperative's deduction for QPAI that includes the following.

- Allowed with respect to the portion of the QPAI to which such payment is attributable
- Identified by the cooperative in a written notice mailed to the patron during the payment period described in IRC §1382(d)[90]

A **qualified payment** to a patron is any amount that meets the following three tests.[91]

1. The payment must be either a patronage dividend or a per-unit retain allocation.
2. The payment must be received by an eligible patron from a qualified agricultural or horticultural cooperative.
3. The payment must be attributable to QPAI with respect to which a deduction is allowed to the cooperative.

The cooperative's deduction is allocated among its patrons on the basis of the quantity or value of business done with or for the patron by the cooperative.[92]

> **Note.** Under IRC §199A(g), a cooperative cannot reduce its income under IRC §1382 for any deduction allowable to its patrons. Thus, the cooperative must reduce its deductions that are allowed for certain payments to its patrons in an amount equal to the §199A(g) deduction allocated to its patrons.

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A patron is allowed a deduction for amounts allocated without regard to wages expense. The only limitation at the patron level is taxable income.[93]

Example 25. Larry and Shellie, a married couple, have taxable income from their farming operation of $200,000 and pay no wages. They receive a $10,000 pass-through IRC §199A amount from a cooperative in which they are patrons. Their net farm income and tentative taxable income is $200,000. Their farm operation initial QBID is $40,000 ($200,000 × 20%). This deduction amount is added to the $10,000 pass-through amount from the cooperative, for a final QBID of $50,000. Therefore, their taxable income is $150,000.

> **Note.** As the example illustrates, a patron of an agricultural or horticultural cooperative that receives a QBID from the cooperative is not subject to the 20% of tentative taxable income limit.[94] Instead, the patron's QBID is limited to taxable income.[95] In addition, a patron who receives a QBID from a cooperative may offset any character of income, including capital gain.

90. IRC §199A(g)(2)(A).
91. IRC §199A(g)(2)(E).
92. IRC §199A(g)(2)(A).
93. IRC §199A(g)(2)(B).
94. Ibid.
95. IRC §199A(g)(1)(A)(ii).

The patron's deduction may not exceed the patron's taxable income for the tax year (determined without regard to the deduction but after accounting for the patron's other deductions under IRC §199A(a)).[96] However, for any **qualified trade or business** of a patron, the initial QBID is reduced by the **lesser** of:

- 9% of the QBI allocable to patronage dividends and per-unit retains received by the patron, or
- 50% of the W-2 wages (subject to payroll tax) with respect to the business.[97]

Example 26. John and Mary operate a dairy and pay no wages. In 2018, they realize a gain of $300,000 from the sale of raised breeding stock, for tentative taxable income of $300,000. However, they also receive a $300,000 IRC §199A deduction from the local cooperative of which they are patrons and sell to. In this situation, John and Mary can offset the IRC §1231 gain from the sale of the raised breeding stock by the $300,000 §199A deduction passed through from the cooperative. Thus, their taxable income is zero.

For a farmer who reports income and expenses on Schedule F, is a patron of an agricultural cooperative, and pays no qualified wages, there are two steps to calculate the tax benefits.

1. The cooperative's final QBID that is passed through to the patron can be applied to offset the patron's taxable income regardless of source.
2. The farmer/patron is entitled to an initial QBID equal to 20% of net farm income, subject to the wage limit that applies to taxpayers with income over the threshold amount ($315,000 for MFJ taxpayers and $157,500 for all others).

Example 27. Michael and Kelsey, a married couple, rent out their land to their son on a crop-share basis. They have 2018 taxable income of $200,000; all from the crop-share rental. They have no wages expense.

They receive a pass-through §199A deduction from their cooperative of $10,000.

They can claim a $40,000 initial QBID ($200,000 × 20%) on the crop-share rental income. In addition, they deduct the $10,000 of the pass-through deduction from the cooperative. Their final QBID equals $50,000 ($40,000 + $10,000). Thus, their taxable income for 2018 is $150,000 ($200,000 – $50,000).

Example 28. Use the same facts as **Example 27,** except Michael and Kelsey's taxable income is $415,000. They have no QP and paid no W-2 wages during 2018. Because their taxable income exceeds the upper income limit of $415,000 for MFJ, they cannot claim a QBID on the crop-share rental income. However, they can still claim the $10,000 passed through from the cooperative.

Observation. Income from rental arrangements between commonly controlled entities (self rentals and other related-party rents) meet the §199A test for a trade or business. Other unrelated rentals are subject to the facts and circumstances of each activity to determine if the taxpayer's involvement is regular and continuous and rises to the level of a trade or business for purposes of QBI. Further guidance from the IRS is needed.[98]

For farmers who pay qualified W-2 wages and sell to agricultural cooperatives that also pay W-2 wages, their initial QBID is reduced by subtracting the lesser of 50% of W-2 wages or 9% of QBI attributable to the income from the cooperative.[99]

Thus, for a farmer with farm income beneath the threshold amount ($315,000 for MFJ taxpayers and $157,500 for all others), the QBID will never be less than 11% (i.e., 20% less 9%).

96. IRC §199A(g)(2)(B).

97. IRC §199A(b)(7).

98. Prop. Treas. Reg. §1.199A-1(b)(13).

99. IRC §199A(b)(7).

Example 29. In 2018, Bart, a married taxpayer who files jointly, receives a $5,000 QBID allocated to him from a cooperative. Bart's Schedule F income is $250,000 and his tentative taxable income is less than $315,000. His schedule F income is $150,000 derived from sales of products to a cooperative and $100,000 to a non-cooperative. Bart pays wages, but they are all paid in commodities. Bart's initial QBID for the Schedule F income is $50,000 ($250,000 × 20%). This is reduced by the **lesser** of the following amounts.

- 9% of income derived from a cooperative, or $13,500 ($150,000 × 9%)
- 50% of wages, or $0

Therefore, Bart's final QBID is $55,000 ($50,000 – $0 + $5,000 QBID from cooperative).

If the farmer is above the income threshold amount, the W-2 wages/QP limit is applied before the 9% limitation. The farmer's QBID cannot exceed 20% of taxable income.[100] To this amount is added any pass-through deduction from the cooperative to produce the total deductible amount.

For farmers who sell agricultural products to non-cooperatives and pay W-2 wages, a deduction of 20% of net farm income is available. If taxable income is less than net farm income, the deduction is 20% of taxable income less capital gains. If taxable income before the QBID exceeds the income threshold amount, the deduction may be reduced on a phased-in basis.

Example 30. Use the same facts as **Example 29,** except that Bart pays $50,000 of qualified wages. Bart's QBID is computed as follows.

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Initial QBID ($250,000 × 20% = $50,000), minus the **lesser** of:

- 9% of income derived from a cooperative ($150,000 × 9% = $13,500); **or**
- 50% of wages ($50,000 × 50% = $25,000).

Bart's final QBID is $41,500 ($50,000 – $13,500 + $5,000).

Example 31. Use the same facts as **Example 29,** except Bart's tentative taxable income is $415,000 and he has qualifying property of $700,000. Bart's final QBID is computed as follows.

The **lesser** of:

- Initial QBID ($250,000 × 20% = $50,000), **or**
- 25% of wages ($0) + 2.5% of $700,000 QP ($700,000 × 2.5% = $17,500)

Minus, the **lesser** of:

- 9% of income derived from a cooperative ($150,000 × 9% = $13,500), **or**
- 50% of wages ($0)

Bart's final QBID is $22,500 ($17,500 – $0 + $5,000 QBID from cooperative).

Observation. Whether a taxpayer receives an advantage from selling agricultural products to a cooperative depends on various factors. In general, a farmer with farm income over the applicable income threshold for their filing status obtains a larger QBID by paying qualified wages if the farmer does not have enough QP to generate the full QBID allowed.

Conversely, a farmer that is below the applicable income threshold derives a larger QBID by not paying qualified wages, or by paying qualified wages in an amount such that half of the wages paid is less than 9% of the farmer's Schedule F income that is attributable to the cooperative.

100. Ibid.

TRUSTS AND ESTATES

Trusts and estates are eligible for a QBID.[101] The QBID applies to income taxed at the trust or estate level, and the apportionment of W-2 wages and QP for purposes of the limit applies as it did for the purposes of the DPAD under former IRC §199.[102] The proposed regulations provide for anti-abuse rules for creation of multiple trusts to avoid exceeding the income threshold amount.[103]

> **Note.** For more information about the QBID rules for trusts and estates, including the anti-abuse rules, see the 2018 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Legislation — Individual Concerns.

ACCURACY-RELATED PENALTY

When a QBID is claimed on a return, an accuracy-related penalty is applied when the understatement of tax exceeds the greater of 5% of the tax required to be shown on the return, or $5,000.[104]

SUMMARY: CALCULATING THE QBID

The basic step-by-step approach to calculating the QBID follows.[105]

Step 1. Determine if the taxpayer's taxable income is below zero. If it is below zero then there is no QBID in the current year. However, the net business loss must be determined for its effect on the following year's QBID.

Step 2. Determine if the taxpayer has a pass-through QBID from a cooperative. If so, the pass-through QBID applies up to the amount of the taxpayer's taxable income. In addition, a computation must be made of the reduced QBID based on the lesser of cooperative income or 50% of W-2 wages.

Step 3. Determine if the taxpayer has tentative taxable income that is composed of net ordinary income. If the taxpayer's ordinary income is fully offset by capital gain (or qualified dividends), there is no QBID except for any amount that is passed through from a cooperative.

Step 4. Determine if the taxpayer has tentative taxable income less than the applicable threshold amount ($315,000 for MFJ taxpayers and $157,500 for other taxpayers).

Step 5. Determine the taxpayer's initial QBI. This determination should be made irrespective of whether the taxpayer has separate trades or businesses. If there is an overall QBL, the loss is carried over to the following year.

Step 6. If the overall QBI from Step 5 is positive and the taxpayer's tentative taxable income is less than the applicable threshold (Step 4), multiply the net positive QBI by 20% to determine the initial QBID. If the taxpayer has multiple trades or businesses, each with positive QBI, their initial QBI for each business is aggregated. The W-2 wages/QP limit does not apply. Determine the final QBID by calculating 20% of the taxpayer's ordinary income (OTI limit). If the taxpayer's tentative taxable income exceeds the applicable threshold, proceed to Step 7.

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101. IRC §199A(f)(1)(B).

102. Ibid.

103. Prop. Treas. Reg. §1.199A-6(d)(3)(v).

104. IRC §6662(d)(1)(C).

105. This step-by-step process is a summary of the discussion of this section of the chapter and is based entirely on the statutory provisions and relevant guidance issued as of August 15, 2018. This process assumes that no specified service businesses are involved.

Step 7. If the taxpayer has only one trade or business, determine the W-2 wages/QP limit to arrive at the reduced QBID. Then determine the final QBID by limiting it to 20% of the taxpayer's ordinary income (i.e., apply the OTI limitation).

Step 8. If the taxpayer has multiple trades or businesses, determine whether the taxpayer's tentative taxable income exceeds the applicable threshold plus the amount of the applicable phasein range ($100,000 for MFJ taxpayers and $50,000 for other taxpayers).

If the taxpayer's tentative taxable income from multiple trades or businesses exceeds the thresholds, apply the W-2 wages/QP limit to each trade or business with positive adjusted QBI to arrive at each business's reduced QBID. Determine the combined QBID.

If all of the trades or businesses have a positive QBI, determine the initial QBID for each business.

Step 9. If multiple trades/businesses exist and some have losses, apportion the amount of losses pro rata to the amount of gains to determine adjusted QBI.

Step 10. Aggregate the taxpayer's separately determined QBIDs to arrive at combined QBID.

Step 11. Determine the final QBID by limiting the combined QBID to 20% of the taxpayer's overall taxable income.

As mentioned earlier, if the taxpayer receives cooperative distributions, the computation of the taxpayer's QBID takes into account those distributions.

COMMODITY CREDIT CORPORATION LOANS AND ELECTIONS

The Commodity Credit Corporation (CCC) is the United States Department of Agriculture's (USDA) financing institution with programs administered by the Farm Service Agency (FSA).[106] Among other responsibilities, the CCC makes commodity and farm storage facility loans to farmers when the farmers' crops are pledged as collateral. These loans are part of the price and income support system of the federal farm programs.[107]

TAX REPORTING OPTIONS

When a farmer seals grain (places it in storage and pledges it as collateral to secure a CCC loan), the farmer retains the ability to forfeit the grain in the future if the loan value exceeds commodity prices. Because most CCC loans are nonrecourse, if the loan plus interest is not paid upon the loan's maturity, forfeiting the commodity to the CCC as full payment for the loan effectively establishes a minimum price. The farmer is protected against price risk, because if the market price of the pledged commodity drops, the farmer can forfeit the grain in full satisfaction of the loan. If the price increases, the grain can be sold and the proceeds used to repay the loan (redeemed). Paying back the loan to the CCC as full payment is known as "redemption." Once redeemed, the farmer can then sell the grain, feed it to livestock, or store it.

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106. *Commodity Credit Corporation.* USDA. [www.fsa.usda.gov/about-fsa/structure-and-organization/commodity-credit-corporation/index] Accessed on May 31, 2018.

107. See, e.g., *Commodity Credit Corporation.* USDA. [www.fsa.usda.gov/about-fsa/structure-and-organization/commodity-credit-corporation/index] Accessed on Jun. 26, 2018.

Handling Loan Proceeds

There are two methods that can be used for tax reporting purposes.

Loan Method. Every farmer treats CCC loans as loans for tax purposes.[108] For a farmer on the cash method of accounting, there is no taxable income from the loan until the year in which the commodity is sold or the crop is forfeited to the CCC in full satisfaction of the loan.[109] If grain is forfeited to the CCC in satisfaction of the loan, the taxpayer receives a Form 1099-A, *Acquisition or Abandonment of Secured Property,* from the USDA. The forfeited loan amount is reported on line 5b of Schedule F with the same amount entered as taxable income on line 5c.

SCHEDULE F (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Profit or Loss From Farming

▶ Attach to Form 1040, Form 1040NR, Form 1041, Form 1065, or Form 1065-B.
▶ Go to *www.irs.gov/ScheduleF* for instructions and the latest information.

OMB No. 1545-0074
2017
Attachment Sequence No. 14

Name of proprietor | Social security number (SSN)

A Principal crop or activity | B Enter code from Part IV ▶ | C Accounting method: ☐ Cash ☐ Accrual | D Employer ID number (EIN), (see instr)

E Did you "materially participate" in the operation of this business during 2017? If "No," see instructions for limit on passive losses ☐ Yes ☐ No
F Did you make any payments in 2017 that would require you to file Form(s) 1099 (see instructions)? ☐ Yes ☐ No
G If "Yes," did you or will you file required Forms 1099? ☐ Yes ☐ No

Part I Farm Income—Cash Method. Complete Parts I and II (Accrual method. Complete Parts II and III, and Part I, line 9.)

1a	Sales of livestock and other resale items (see instructions)	1a				
b	Cost or other basis of livestock or other items reported on line 1a	1b				
c	Subtract line 1b from line 1a				1c	
2	Sales of livestock, produce, grains, and other products you raised				2	
3a	Cooperative distributions (Form(s) 1099-PATR)	3a		3b Taxable amount	3b	
4a	Agricultural program payments (see instructions)	4a		4b Taxable amount	4b	
5a	Commodity Credit Corporation (CCC) loans reported under election				5a	
b	CCC loans forfeited	5b		5c Taxable amount	5c	
6	Crop insurance proceeds and federal crop disaster payments (see instructions)					
a	Amount received in 2017	6a		6b Taxable amount	6b	
c	If election to defer to 2018 is attached, check here ▶ ☐			6d Amount deferred from 2016	6d	
7	Custom hire (machine work) income				7	
8	Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)				8	
9	**Gross income.** Add amounts in the right column (lines 1c, 2, 3b, 4b, 5a, 5c, 6b, 6d, 7, and 8). If you use the accrual method, enter the amount from Part III, line 50. See instructions ▶				9	

Part II Farm Expenses—Cash and Accrual Method. Do not include personal or living expenses. See instructions.

Car and truck expenses (see | 23 Pension and profit-sharing plans | 23

Farmers using the loan method (and their tax preparers) should be aware that the loan method can create high income in the year the grain is sold with no corresponding net cash flow. This happens because the grain proceeds were used to repay the loan.

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108. IRC §77 provides an election to change that tax treatment to income in the year the loan is taken out.

109. Ibid.

Income Method. CCC loans may, by election (and without IRS permission), be treated as income in the year the loan proceeds are received.[110] The election can be made at any time.[111] However, the IRS ruled that if a farmer elects to treat CCC loans as income, it applies to all loans originating that year.[112]

The election constitutes an adoption of an accounting method.[113] An election statement reporting the details of the loan must be attached to the farmer's return for the year the election is made.[114] Additionally, the election to treat CCC loans as income applies to all commodities for that taxpayer.[115]

The CCC loan is not actually income. Rather, the amount reported as income is the cash proceeds of the CCC loan, which then serves as the grain's income tax basis.[116] The amount of the loan is entered on line 5a of Schedule F.

A taxpayer reporting CCC loans as income can switch automatically to treating amounts received as loans.[117] Previous loans continue to be treated as if the election to report loans as income was still in effect. Under IRS guidance, the change is made on a "cut-off" basis.[118] Therefore, when a taxpayer changes CCC loan reporting methods, the new method applies to current year and subsequent loans. That means that a farmer can report loans using both methods until prior loans are satisfied.

In addition, even if a farmer had made the election to report the CCC loan as income within the past five years, the farmer is still eligible to switch to the loan method. The IRS waives the 5-year prohibition that normally applies to automatic changes.[119] However, Form 3115, *Application for Change in Accounting Method,* must be attached to the return, noting that the change is being made under the automatic consent procedures of Rev. Proc. 2015-14. A copy of Form 3115 must be sent to the IRS in Washington, D.C.[120]

TAX PLANNING ISSUES

It is important to understand the tax ramifications of making or not making the election to treat CCC loans as income. This is illustrated by the following example.

Example 32. Dusty is a farmer who participates in a 3-year farmer loan reserve program. If a year of high prices occurs and all of the grain under the 3-year loan reserve program is sold, the result is a spike in Dusty's income for that year. That is because the grain is considered income in the year that it is disposed of if an election was not made to treat the loan as income.

In order to avoid this result, Dusty can treat the loans as income. This means he reports the crop income in the year he receives the loan proceeds. This has the favorable result of smoothing out Dusty's year-to-year income by offsetting the income from the crop with the expenses of raising the crop. When the crop is eventually sold, Dusty has taxable income only to the extent that the sale price exceeds the loan amount.

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110. IRC §77.
111. IRC §77(a).
112. Ltr. Rul. 8819004 (Jan. 22, 1988).
113. Treas. Reg. §1.77-1.
114. See IRS Pub. 225, *Farmer's Tax Guide,* and Schedule F Instructions.
115. Treas. Reg. §1.77-1.
116. IRC §1016(a)(8).
117. Rev. Proc. 2002-9, 2002-1 CB 327, Appendix §1.01(1).
118. Ibid.
119. Rev. Proc. 2015-13, 2015-5 IRB 419 (§5.05).
120. Rev. Proc. 2015-13, 2015-5 IRB 419 (§6).

Alternatively, there is an advantage to not paying tax any sooner than required. Farmers, particularly those in higher tax brackets, may not want to treat CCC loans as income. The preference may be to defer the income as long as possible without paying tax on it. It is an important consideration for tax planning purposes to consider whether to treat CCC loans as income or as loans.

The following points should be kept in mind regarding the income tax treatment of various dispositions of CCC loans and commodities.

1. If the loan is paid by forfeiting the commodity to the CCC, no income is reported if an election was made to treat the loan as income upon receipt. The farmer's basis in the grain offsets the loan liability. However, there could be either a gain or loss on the farmer's Schedule F if the loan liability is more or less than the farmer's basis in the grain. **If no election is made,** the loan amount is reported as income upon redemption.

2. If the commodity is redeemed by paying off the loan with cash, the farmer has a basis in the commodity equal to the loan amount if an election was made to treat the loan as income. If no election was made, the farmer has a zero basis in the commodity.

3. If the redeemed commodity is sold and an election to treat the loan as income was made, the farmer has income (or loss) equal to the sale price of the commodity less the amount of the loan (which is the basis in the commodity). If no election was made, the farmer has income equal to the selling price of the commodity.

4. If the redeemed commodity is fed to livestock and an election was made to treat the loan as income, the farmer has a feed deduction equal to the amount of the loan (which is the basis in the feed). If no election was made, the farmer is not eligible for a feed deduction.

5. Regardless of whether the CCC loan is treated as a loan or as income, interest that a cash-basis farmer pays to the CCC on the loan is deductible in the year it is paid.

Redeeming the CCC Loan in the Same Year It Is Taken Out

As mentioned previously, normally the repayment of a CCC loan has no tax impact. This is regardless of whether the taxpayer made an election to treat the loan as income.

If a farmer elected to treat CCC loans as income, the courts are divided as to the outcome **if the loans are redeemed in the same year they are taken out.** The Fifth Circuit Court of Appeals held that no income is realized from the loan on a crop redeemed in the same year.[121] On the other hand, the Ninth Circuit Court of Appeals took the position that the loan triggers income even though it is redeemed in the same year.[122]

Impact of Market Gains on CCC Loans

Similar rules to those discussed earlier apply to market gains triggered under the CCC nonrecourse marketing assistance loan program. The amount that a farmer must repay for a loan that is secured by an eligible commodity is tied to the lower of the loan rate or the world market price for the commodity on the loan repayment date. If repayment occurs when the world price is lower than the loan rate, the farmer has "market gain" on the difference. For repayment in cash, the gain is reported on a Form CCC-1099-G, *Certain Government Payments.* When a CCC certificate is used to repay the loan, there is no Form 1099 reporting.

The farmer's tax treatment of the market gain is tied to how the farmer treats CCC loans for tax purposes. For farmers that treat CCC loans as loans, the market gain is reported on line 4a of Schedule F and taxable income is reported on line 4b. If the farmer elected to treat CCC loans as income, the market gain is not taxable income. Instead, it reduces the basis in the commodity and defers income until the sale of the grain occurs.

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121. *Thompson v. Comm'r*, 322 F.2d 122 (5th Cir. 1963), *aff'g and rev'g,* 38 TC 153 (1962).

122. *U.S. v. Isaak,* 400 F.2d 869 (9th Cir. 1968).

LIVESTOCK SOLD OR DESTROYED BECAUSE OF DISEASE

Although the loss of livestock due to disease does not occur frequently, when it does, the loss can be large. Fortunately, the Code provides a special rule for handling the loss. The rule is similar to the rules that apply when excess livestock are sold because of weather-related conditions.

INVOLUNTARY CONVERSION TREATMENT

Gain Deferral

Similar to the drought sale rules, livestock that are sold or exchanged because of disease may not result in taxable gain. If the proceeds of the transaction are reinvested in replacement animals that are similar or related in service or use (for example, dairy cows for dairy cows) **within two years of the close of the tax year** in which the diseased animals were sold or exchanged, there is no taxable gain.[123] Specifically, the replacement period ends two years after the close of the tax year in which the involuntary conversion occurs and any part of the gain is realized.[124]

Under these circumstances, the gain on the animals disposed of is not subject to tax. Instead, the gain is deferred until the replacement animals are sold or exchanged in a taxable transaction. The taxpayer's basis in the replacement animals must be reduced by the unrecognized gain on the disposed of animals that were either destroyed, sold, or exchanged.[125]

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Note. Involuntary conversion treatment is available for losses due to the death of livestock from disease. It does not matter whether there is normal death loss or a disease causes massive death loss.[126] In addition, involuntary conversion treatment applies to livestock that are sold or exchanged because they were exposed to disease.[127]

Gain Recognition

Gain is realized to the extent money or dissimilar property is received in excess of the livestock's tax basis. For cash-method farmers, raised livestock have no tax basis. Therefore, gain is realized upon receipt of any compensation for the animals.[128]

If there is gain recognition on the transaction, it occurs to the extent that the net proceeds from the involuntary conversion are not invested in qualified replacement property.[129] The gain (or loss) is reported on Form 4797, *Sales of Business Property*. A statement must be attached to the return for the year in which gain is realized (e.g., the year in which insurance proceeds are received).[130] The statement should include the date of the involuntary conversion as well as information concerning the insurance (or other reimbursement) received. If the replacement livestock are received before the tax return is filed, the attached statement must include a description of the replacement livestock, the date of acquisition, and their cost. If the animals will be replaced in a year after the year in which the gain is realized, the attached statement should evidence the taxpayer's intent to replace the property within the 2-year period. If the animals are not replaced during the 2-year replacement period, the taxpayer must amend the tax return in the year the gain was realized to recognize the gain.

123. IRC §1033(a).

124. IRC §1033(a)(2)(B)(i).

125. Treas. Reg. §1.1033(b)-1.

126. Rev. Rul. 61-216, 1961-2 CB 134.

127. Treas. Reg. §1.1033(d)-1.

128. See, e.g., *DeCoite v. Comm'r*, TC Memo 1992-665 (Nov. 17, 1992).

129. IRC §1033(a)(2)(A).

130. Treas. Reg. §1.1033(a)-2(c)(2); IRS Pub. 544, *Sales and Other Dispositions of Assets.*

Disease is not a Casualty

Under casualty loss rules, a deduction can be taken for the complete or partial destruction of property resulting from an identifiable event that is sudden, unexpected, or unusual.[131] Livestock losses because of disease generally are not eligible for casualty loss treatment because the loss is progressive rather than sudden. Consequently, casualty loss treatment under IRC §165(c)(3) does not apply.

However, this provision does not apply to losses due to livestock disease.[132] Involuntary conversion treatment applies, even though the loss is not "sudden."[133]

What is a "Disease"? While a livestock disease need not be sudden in nature for the sale or exchange of the affected livestock to be treated under the involuntary conversion rules, a genetic defect is not a disease.[134]

Livestock that consume contaminated feed and are lost as a result can be treated under the involuntary conversion rules.[135] In addition, the IRS ruled that honeybees destroyed due to nearby pesticide use qualified for involuntary conversion treatment.[136]

Definition of Livestock

IRC §1033(d) provides that if livestock are destroyed, sold, or exchanged because of disease, then involuntary conversion treatment applies. The definition of "livestock" under IRC §1231 applies for involuntary conversion treatment purposes.[137] Under Treas. Reg. §1.1231-2, livestock includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals. It does not include poultry, chickens, turkeys, pigeons, geese, other birds, fish, frogs, reptiles, etc.

Environmental Contamination

If it is not feasible to reinvest the proceeds from involuntarily converted livestock into other like-kind livestock due to soil or other environmental contamination, the proceeds can be invested in non-like-kind farm property or real estate used for farming purposes.[138] A communicable disease may not be considered an environmental contaminant.[139]

UPDATE ON SELF-EMPLOYMENT TAX ON FARM RENTAL INCOME

Self-employment (SE) tax applies to income that is derived from a trade or business. By statute, rentals from real estate and from personal property leased with the real estate are excluded from the definition of net earnings from self-employment. Likewise, income from crop share and/or livestock share rental arrangements for landlords who do not materially participate in the farming or ranching operation are not classified as SE income. If the individual materially participates under a crop or livestock share lease, however, the rent is SE income.[140] Income received under a cash-rental arrangement is not subject to SE tax.

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131. Rev. Rul. 72-592, 1972-2 CB 101.

132. IRC §1033(d).

133. See Rev. Rul. 59-102, 1959-1 CB 200.

134. Rev. Rul. 59-174, 1959-1 CB 203.

135. Rev. Rul. 54-395, 1954-2 CB 143.

136. Rev. Rul. 75-381, 1975-2 CB 25.

137. Treas. Reg. §1.1231-2(a)(3).

138. IRC §1033(f).

139. *Miller v. U.S.,* 615 F. Supp. 160 (E.D. Ky. 1985).

140. IRC §1402(a)(1).

A lease is a material participation lease if it includes **both** of the following.

1. It provides for material participation in the production or in the management of the production of agricultural or horticultural products, and
2. There is material participation by the landlord.[141]

While a written lease is not required, a written lease certainly makes a material participation arrangement easier to establish (or not established, if that is desired).

There are a number of questions to consider related to leasing farmland.

- How is a lease of farmland to an operating entity in which the lessor is also a material participant in the operating entity treated?
- Does the real estate exemption from the definition of net earnings from self-employment apply to the taxpayer?
- Does the type of lease or the rate of rent charged under the lease matter?

In 1995, the Tax Court rendered an important decision on the first question, which also answered the second question.[142] Later, the U.S. Court of Appeals for the Eighth Circuit carved out an exception from the 1995 Tax Court decision for fair market leases.[143] In 2017, the Tax Court, in a full Tax Court opinion, applied the Eighth Circuit's analysis and holding to a case with similar facts coming from Texas — a jurisdiction outside the Eighth Circuit.[144]

THE *MIZELL* CASE

In *Mizell v. Comm'r*,[145] Mr. Mizell was a farmer who, in 1986, structured his farming operation to become a 25% co-equal partner in an active farming partnership with his three sons. In addition, in 1988, he leased about 730 acres of farmland to the farm partnership. The lease called for Mr. Mizell to receive a one-quarter share of the crop, and the partnership was responsible for all expenses. Mr. Mizell reported his 25% share of partnership income as SE earnings. However, the crop-share rent on the land lease was treated as rents from real estate that was exempt from SE tax.

The IRS disagreed with that tax treatment of the land rent, assessing SE tax on the crop-share lease income for the years 1988, 1989, and 1990. The parties agreed that Mr. Mizell 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 light of the entire farming enterprise in measuring SE income. Thus, the IRS's position was that the landlord role **could not be separated** from the employee or partner role. That meant that any employee or partner-level participation by the landowner triggered SE tax on the rental income.

Mr. 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. The IRS looked to the overall farming arrangement to find a sufficient level of material participation on Mr. Mizell's part, and Mr. Mizell confined the analysis to the terms of the lease, which was not a material participation lease.

141. Ibid.

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

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

144. *Martin v. Comm'r,* 149 TC No. 12 (2017).

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

While rents from real estate, whether cash-rent or crop-share, are excluded from the definition of SE income, there is an exception that applies if three criteria are met.[146]

1. The rental income is derived under an arrangement between the owner and lessee which 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, agreeing with the IRS, 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 Mr. Mizell and the farming partnership. By measuring material participation with consideration to both the crop-share lease and Mr. Mizell's obligations as a partner in the partnership, the court found that the rental income must be included in the petitioner's net earnings for SE purposes.

Following its win in *Mizell*, the IRS privately ruled in 1996 that a married couple who **cash-rented** 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.[147]

Implications of *Mizell*

The *Mizell* decision was a landmine that posed a clear threat to the common arrangement in agriculture in which an individual leases farmland to an operating entity in which the individual is also a material participant. Importantly, the type of lease was apparently immaterial to the court. On that point, 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 material participation of the landowner.

Exception to the *Mizell* "Arrangement" Theory

The Tax Court, in 1998, decided three more *Mizell*-type cases. In *Bot v. Comm'r,*[148] the court determined that rental income (at the rate of $90 per acre) received by a wife for 240 acres of land, paid to her by her husband's farm proprietorship, was subject to SE tax. The wife also received an annual salary from the proprietorship of approximately $15,000, and the court said that the rental amount and the salary amounted to a single arrangement.

In *Hennen v. Comm'r,*[149] the court again held that SE tax applied to rental income that a wife received on land leased to her husband's farming business. Like Mrs. Bot, Mrs. Hennen worked for the farming business and was paid a salary (approximately $3,500 per year).

The *McNamara*[150] case also involved a husband and wife who owned land that they leased to their farming C corporation under a written, cash-rent lease. The rent payment averaged about $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. She was paid a nominal amount (approximately $2,500 annually). The court again determined that the rental arrangement and the wife's employment should be combined, which meant that the rental income was subject to SE tax.

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146. IRC §1402(a)(1); Treas. Reg. §1.1402(a)-4(b)(1).
147. TAM 9637004 (May 6, 1996).
148. *Bot v. Comm'r*, TC Memo 1999-256 (Aug. 3, 1999).
149. *Hennen v. Comm'r,* TC Memo 1999-306 (Sep. 16, 1999).
150. *McNamara v. Comm'r,* TC Memo 1999-333 (Oct. 4, 1999).

All three cases were consolidated on appeal to the U.S. Court of Appeals for the Eighth Circuit.[151] The Eighth Circuit, reversing the Tax Court, determined that the lessor/lessee relationship was to be analyzed separate and distinct from the employer-employee relationship. The Eighth 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 self-employment 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."

The Eighth Circuit remanded the case 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. The IRS could not establish a connection. The rents were cash rents that were at or slightly below FMV. However, the IRS later issued a nonacquiescence to the Eighth Circuit's decision.[152] The IRS planned to continue to litigate the issue outside of the Eighth Circuit.

MORE LITIGATION

As the nonacquiescence indicated, the IRS continued to litigate the matter and two more cases found their way to the Tax Court. In *Johnson v. Comm'r,*[153] the petitioners had an oral agreement to cash lease 617 acres of land to their farm corporation. They also had an oral employment agreement with the corporation and received a nominal salary. The farming operation was located within the Eighth Circuit, which meant that if the land rental and the employment agreement were two separate arrangements, the land rental income would not be subject to SE tax. Ultimately, the Tax Court determined that the rental amount under the lease was representative of a fair market rate of rent, and the rental payments were not tied to any services the petitioners provided to the farming corporation. The compensation paid to the petitioners was also not understated.

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In *Solvie v. Comm'r,*[154] the Tax Court reached a different conclusion on a similar set of facts to those involved in *Johnson.* In *Solvie*, the petitioners leased real estate to their controlled corporation and received compensation as corporate employees. Later, an additional hog barn was constructed, which increased the total rent paid to the petitioners. The IRS claimed that this was subject to SE tax. The Tax Court agreed because the additional rent was much greater than the rental amounts they received from the corporation for the other hog buildings even though the new building had a smaller capacity. The court noted that the petitioners' wages did not increase even though their overall hog production increased, and the additional rent was computed on a per-head basis. This meant that no building rent was paid if there was no hog production.

Downfall of *Mizell?*

In *Martin v. Comm'r*,[155] the full Tax Court delivered its most recent opinion concerning the SE tax treatment of leases of farmland to an operating entity in which the lessor is also a material participant. Under the facts of the case, the petitioners, a married couple, operated a farm in Texas (a state not located within the Eighth Circuit's jurisdiction).

In late 1999, they built the first of eight poultry houses to raise broilers under a production contract with a large poultry integrator. The petitioners formed an S corporation in 2004, and set up oral employment agreements with the S corporation based on an appraisal for the farm, which guided them as to the cost of their labor and management services. They established their salaries at levels consistent with other growers. The wife provided bookkeeping services and the husband provided labor and management.

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151. *McNamara, et al. v. Comm'r,* 236 F.3d 410 (8th Cir. 2000).

152. AOD 2003-003, IRB 2003-42 (Oct. 22, 2003).

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

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

155. *Martin v. Comm'r,* 149 TC No. 12 (2017).

In 2005, they assigned the balance of their contract to the S corporation, which made the corporation the "grower" under the contract. The petitioners then entered into a lease agreement with the S corporation. Under the agreement, the petitioners rented their farm to the S corporation, and the S corporation was to pay rent of $1.3 million to the petitioners over a 5-year period. The court noted that the rent amount was consistent with other growers under contract with the integrator.

The petitioners reported rental income of $259,000 and $271,000 for 2008 and 2009, respectively. The IRS determined that the amounts were subject to SE tax because the petitioners were engaged in an "arrangement" that required their material participation in the production of agricultural commodities on their farm.

The Tax Court noted that the IRS agreed that the facts of the case were consistent with *McNamara.* In addition, the court determined that the Eighth Circuit's rationale in *McNamara* was persuasive and that the "derived under an arrangement" language in IRC §1402(a)(1) meant that a nexus had to be present between the rents the petitioners received and the "arrangement" that required their material participation. Accordingly, there must be a connection between the real property lease agreement and the employment agreement. The court noted the petitioners received rent payments that were consistent with the integrator's other growers for the use of similar premises. That fact was sufficient to establish that the rental agreement stood on its own as an appropriate return on the petitioners' investment in their facilities. Similarly, the employment agreement was appropriately structured as a part of the petitioners' conduct of a legitimate business.

Importantly, the court noted that the IRS failed to brief the nexus issue, relying solely on its nonacquiescence to *McNamara.* The IRS relied on the court to broadly interpret "arrangement" to include all contracts related to the S corporation. **Accordingly, the court held that the petitioner's rental income was not subject to SE tax.**

IMPLICATIONS

The cases discussed in this section point out that leases should be carefully drafted to specify that the landlord is not providing any services or participating as part of the rental arrangement.

- Services and labor participation should remain solely within the domain of the employment agreement.
- Leases in which the landlord also participates in the lessee entity must be tied to market value for comparable land leases. If the rental amount is set too high, the IRS could argue that the lease is part of "an arrangement" that involves the landlord's services. If the lessor provides services, a separate written employment agreement should describe the duties and compensation for those services.

A dissenting judge in *Martin* complained that the IRS should not have the burden of producing evidence of a nexus between the land lease and the employment agreement once the petitioner establishes that the land lease is a fair market lease. Another dissenter would have continued to apply the *Mizell* arrangement theory outside of the Eighth Circuit.

The IRS did not appeal *Martin.*

SPOUSAL QUALIFIED JOINT VENTURE

Some spousal business ventures can elect out of the partnership rules for federal tax purposes as a qualified joint venture (QJV).[156] While the election eases the tax reporting requirements for husband-wife joint ventures, the election also makes an important change to IRC §1402 as applied to rental real estate activities. This can lay a trap for the unwary.

There are several questions to address related to spousal farming operations.

1. When is making a QJV election a good planning strategy?
2. When should the QJV election be avoided?
3. Are there implications for farm program payment limitation planning?
4. Is there any impact on SE tax?

JOINT VENTURES AND PARTNERSHIP RETURNS

A joint venture is simply an undertaking of a business activity by two or more persons when the parties involved agree to share in the profits and loss of the activity. This is similar to the Uniform Partnership Act's definition of a partnership.[157] The Code defines a partnership in a negative manner by describing what is not a partnership.[158] The IRS follows the UPA definition of a partnership. It specifies that a business activity conducted in a form jointly owned by spouses (including a husband-wife limited liability company (LLC)) creates a partnership. These partnerships are required to file Form 1065, *U.S. Return of Partnership Income,* and issue each spouse separate Schedules K-1, *Partner's Share of Income, Deductions, Credits, etc.* The spouses then aggregate the Schedules K-1 on page 2 of their Schedule E. Each spouse must file separate Schedules SE, *Self-Employment Tax.*

Note. For a spousal general partnership, each spouse's share of partnership income is subject to SE tax.[159]

Although the IRS's position creates a tax compliance hardship, in reality, a partnership return does not have to be filed for every husband-wife operation. For example, if the enterprise does not meet the basic requirements to be a partnership under the Code (such as not carrying on a business, financial operation, or venture as required by IRC §7701(a)(2)), no partnership return is required. A spousal joint venture can elect out of partnership treatment if it is formed for "investment purposes only" and not for the active conduct of business and the income of the couple can be determined without the need for a partnership calculation.[160]

156. IRC §761(f).
157. UPA §101(11).
158. IRC §§761(a) and 7701(a)(2).
159. See, e.g., *Norwood, et ux. v. Comm'r,* TC Memo 2000-84 (Mar. 13, 2000).
160. IRC §761(a).

TAX REPORTING

A spousal business activity (in which both spouses materially participate in accordance with IRC §469(h)) can elect to be treated as a QJV. Under this election, the activity is **not** treated as a partnership for tax purposes. In essence, the QJV provision equates the treatment of spousal LLCs in common-law property states with that of community property states. In Rev. Proc. 2002-69, the IRS specified that husband-wife LLCs in community property states can disregard the entity.[161]

> **Observation.** The IRS claims on its website that a QJV includes only those businesses that are owned and operated by spouses as co-owners and not those that are in the name of a state law entity (including a general or limited partnership or limited liability company). According to the IRS website, spousal LLCs, for example, are not eligible for the election.[162] However, this assertion is not made in Rev. Proc. 2002-69. There does not appear to be any authority that bars a spousal LLC from making the QJV election.

With a QJV election, each spouse files as a sole proprietor to report their proportionate share of income and deductions of the business activity.[163]

Making the Election

The Form 1065 instructions provide guidance on the election. The instructions specify **that the election is made simply by not filing a Form 1065** and dividing all income, gain, loss, deduction, and credit between the spouses in accordance with each spouse's interest in the venture. Each spouse must file a separate Schedule C, C-EZ, or F reporting that spouse's share of income, deduction, or loss. Each spouse also must file a separate Schedule SE to report their respective shares of SE income from the activity, with each spouse then receiving credit for their share of the net SE income for social security benefit eligibility purposes.

For spousal rental activities when income is reported on Schedule E, a QJV election may not be possible.[164] Reporting income on Schedule E constitutes an election out of Subchapter K (partnership taxation). A taxpayer may only obtain Subchapter K treatment (and, therefore, IRC §761(f)) with the IRS's permission. This must be requested within the first 30 days of the tax year.

In general, electing QJV status does not change a married couple's total federal income tax liability or total SE tax liability, but it does eliminate the need to file Form 1065 and the related Schedules K-1. In that regard, the QJV election can provide a simplified filing method for spousal businesses. It can also remove a potential penalty for failure to file a partnership return. That penalty is $200 per partner for each month (or fraction thereof) the partnership return is late, capped at 12 months.[165]

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161. Rev. Proc. 2002-69, 2002-2 CB 831.

162. *Election for Married Couples Unincorporated Businesses.* Feb. 17, 2018. IRS. [www.irs.gov/businesses/small-businesses-self-employed/election-for-married-couples-unincorporated-businesses] Accessed on Jun. 1, 2018.

163. Ibid.

164. *Election for Married Couples Unincorporated Businesses.* IRS. [www.irs.gov/businesses/small-businesses-self-employed/election-for-married-couples-unincorporated-businesses]. Accessed on Aug. 16, 2018.

165. Instructions for Form 1065.

To elect QJV status, the following criteria must be satisfied.[166]

1. The activity must involve the conduct of a trade or business.
2. The only members of the joint venture are spouses.
3. Both spouses elect the application of the QJV rule.
4. Both spouses materially participate in the business.
5. The spouses file a joint tax return for the year.

Note. "Material participation" is defined in accordance with the passive activity loss rules of IRC §469(h), except that IRC §469(h)(5) does not apply. Consequently, whether a spouse materially participates in the business is determined independently of the other spouse.

SE TAX AND FEDERAL FARM PROGRAM PAYMENT LIMITATIONS

The QJV election affects SE tax and, for farmers, eligibility for federal farm program payments.

SE Tax

Under IRC §1402(a), net earnings from self-employment are subject to SE tax. Net earnings from self-employment are defined as income derived by an individual from any trade or business carried on by such individual.

IRC §1402(a)(17) specifies that, when a QJV election is made, each spouse's share of income or loss is taken into account as provided in IRC §761(f) in determining SE tax. IRC §761(f)(1)(C) specifies that, "each spouse shall take into account such spouse's respective share of such items as if they were attributable to a trade or business conducted by such spouse as a sole proprietor." This means that the QJV election does not avoid the imposition of SE tax.

Federal Farm Program Participation

Active Engagement Test. For farm couples that participate in federal farm programs, when one spouse satisfies the active engagement test, each spouse **may** qualify for a payment limitation.[167] To be considered actively engaged in farming as a separate person, a spouse must satisfy three tests.[168]

1. The spouse's share of profits or losses from the farming operation must be commensurate with the spouse's contribution to the operation.
2. The spouse's contributions must be "at risk."
3. The spouse must make a significant contribution of capital, equipment, or land (or a combination of these) **and** active personal labor or active personal management (or a combination).

For the spouse's contribution to be "at risk," there must be a possibility that a nonrecoverable loss may be suffered. Similarly, contributions of capital, equipment, land, labor, or management must be material to the operation to be a "significant contribution." The spouse's involvement, to warrant separate-person status, must not be passive.

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166. IRC §761(f)(1).

167. 7 USC §§1308-1(b) and 1308-1(c)(6).

168. 7 USC §1308-1(b)(2).

The active engagement test is relaxed for farm operations in which a majority of the "persons" are individuals who are family members.[169] However, it is not possible for a spouse to sign up for program payments as a separate person from the other spouse based on a contribution of land the spouse owns in return for a share of the program payments. This is the case because the use of the spouse's contributed land must be in return for the spouse receiving rent or income for the use of the land based on the land's production or the farming operation's operating results.

In this regard, spouses who sign up for two separate payment limitations under the farm programs are certifying that they each are actively involved in the farming operation. Under the farm program rules, for each spouse to be actively involved, both spouses must be significantly involved in the farming operation **and bear a risk of loss.**

From a tax reporting standpoint, however, the couple may have a single enterprise. The income from the enterprise is reported on Schedule C as a sole proprietorship, or on a single Schedule F with the income split into two equal shares for SE tax purposes. In these situations, the IRS could assert that a partnership filing is required (in common-law property states). Under these circumstances, the QJV election could be utilized and result in filing two Schedules C. As mentioned previously, this is a simpler process than filing a partnership return, and it avoids the possibility of having penalties imposed for failing to file a partnership return.

Filing a QJV election subjects the income of both spouses (including each spouse's share of government payments) to SE tax. That eliminates any argument that at least one spouse's income should not be subjected to SE tax because the spouse was only actively involved (for purposes of the farm program eligibility rules) but not engaged in a trade or business (for SE tax purposes).

Separate "Person" Status and Material Participation. Can both spouses qualify for separate "person" status for federal farm program purposes but have only one of them be materially participating in the farming operation for SE tax purposes? While the active engagement rules are similar to the rules for determining whether income is subject to SE tax, the satisfaction of these rules is meaningless on the SE tax issue, according to the U.S. Tax Court.

In *Vianello v. Comm'r*,[170] the taxpayer was a CPA who operated an accounting firm in the Kansas City area during the years at issue. In 2001, the petitioner acquired 200 acres of cropland and pasture in southwest Missouri approximately 150 miles from his office. At the time of the acquisition, a tenant (pursuant to an oral lease with the prior owner) had planted the cropland to soybeans. Under the lease, the tenant deducted the cost of chemicals and fertilizer from total sale proceeds of the beans and paid the landlord one-third of the amount of the sale. The petitioner never personally met the tenant during the years at issue, but the parties did agree via telephone to continue the existing lease arrangement for 2002.

Accordingly, the tenant paid the expenses associated with the 2001 and 2002 soybean crops and provided the necessary equipment and labor. The tenant made all the decisions about raising and marketing the crop and paid the petitioner one-third of the net proceeds. The tenant also mowed the pasture and maintained the fences. Ultimately, a disagreement between the petitioner and the tenant resulted in the lease being terminated in early 2003, and the petitioner had another party plow under the fall-planted wheat in the spring of 2004 prior to the planting of Bermuda grass.

The petitioner bought two tractors in 2002 and a third tractor and hay equipment in 2003. He bought another 50 acres from a neighbor in late 2003.

169. 7 CFR Part 1400.

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

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

The Tax Court determined that the petitioner was not engaged in the trade or business of farming for 2002 or 2003. The court noted that the tenant paid all the expenses associated with the 2002 soybean crop and made all of the cropping decisions. In addition, the court noted that the facts were unclear as to whether the petitioner was responsible under the lease for reimbursing the tenant for input costs in the event of an unprofitable harvest. Importantly, the court noted that the USDA's determination that the petitioner's revocable trust satisfied the active engagement test and was a co-producer with the tenant for farm program eligibility purposes "has no bearing on whether petitioner was engaged in such a trade or business for purposes of section 162(a)…" The Tax Court specifically noted that the regulations under IRC §1402 "make it clear that petitioner's efforts do not constitute production or the management of the production as required to meet the material participation standard." That is a key point. The petitioner's revocable trust (in essence, the taxpayer) satisfied the active engagement test for payment limitation purposes (according to the USDA), but the petitioner was **not** engaged in the trade or business of farming either for deduction purposes or SE tax purposes. The USDA's determination of participation is not controlling on the IRS.

Vianello reaffirms the point that the existence of a trade or business is determined on a case-by-case basis according to the facts and circumstances presented. The case provides additional clarity on the point that satisfaction of the **USDA's active engagement test does not necessarily mean that the taxpayer is engaged in the trade or business of farming for SE tax purposes.** In spousal farming operations, *Vianello* supports the position that both spouses can be separate persons for payment eligibility purposes, but only one of them may be deemed to be in the trade or business of farming for SE tax purposes.

Note. The case may support an argument that satisfaction of the active engagement test by both spouses does not necessarily create a partnership for tax purposes. However, that is probably a weaker argument because *Vianello* did not involve a spousal farming situation.

Vianello may eliminate the need to make a QJV election in spousal farming situations. However, without the election, it is possible that the IRS could deem spouses to be in a partnership, thereby triggering the requirement to file a partnership return.

Rental Real Estate

Real estate rental income is excluded from the general definition of net earnings from self employment.[171] Therefore, for rental property in a partnership (or rental real estate income of an individual), SE tax is not imposed.

The Form 1065 instructions state that if the QJV election is made for a spousal rental real estate business, each spouse must report their share of income and deductions on Schedule E. Rental real estate income generally is not included in net earnings from self employment and generally is subject to the passive loss limitation rules. Electing QVC status does not alter the application of SE tax or the passive loss limitation rules.[172]

171. IRC §1402(a)(1).

172. Instructions for Form 1065; See also CCA 200816030 (Mar. 18, 2008).

Observation. While the QJV election may not be problematic in a year when a loss results, SE tax complications can occur when there is positive income for the year. In an attempt to avoid SE tax, it is not possible to elect out of QJV treatment by filing a Form 1065. The QJV election can be revoked only with the IRS's consent. Likewise, it is probably not possible to intentionally fail to qualify for QJV status (e.g., by transferring an interest in the business to a nonspouse) to avoid SE tax in an income year following a year (or years) of reducing self employment from passed-through losses. Such a move would allow the IRS to assert that the transfer of a minimal interest to a disqualified person or entity violates the intent of Subchapter K.

SUMMARY

The QJV election can be used to simplify the tax reporting requirement for certain spousal businesses that would otherwise be required to file as a partnership. This includes spousal farming operations when each spouse qualifies as a separate person for payment limitation purposes. However, the election does not eliminate SE tax on each spouse's share of income.

RESEARCH AND DEVELOPMENT

RESEARCH AND EXPERIMENTAL EXPENSES

Deductions for R&E Expenses Under Old Law

Prior to the passage of the TCJA, taxpayers could elect to deduct the amount of certain reasonable research or experimental (R&E) expenditures paid or incurred in connection with a trade or business.[173] Instead of making the election, a taxpayer could forgo a current deduction, capitalize their research expenses, and recover them ratably over the useful life of the research, up to five years. Alternatively, an election could be made to recover them over a period of 10 years.[174] By doing so, the taxpayer would avoid AMT preferences and adjustments.

Generally, no current deduction under IRC §174 is allowable for expenditures for the acquisition or improvement of land or of depreciable or depletable property used in connection with any research or experimentation. In addition, no current deduction is allowed for research expenses incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, including oil and gas.

Qualified research is defined as developing a product that can be used in the taxpayer's trade or business. It is an activity or project that a taxpayer undertakes to create a new or improved component of the taxpayer's business utilizing a systemic experimentation process that relies on principles of physical or biological sciences, engineering, or computer science that is designed to evaluate one or more alternatives to achieve a result that was uncertain when the research activity began.[175]

173. IRC §174.

174. Ibid.

175. IRC §41; 2018 Instructions for Form 6765, *Credit for Increasing Research Activities*.

Deductions for R&E Expenses under the TCJA

The TCJA provides that for amounts paid or incurred in tax years beginning after December 31, 2021, specified R&E expenses incurred in the United States must be capitalized and amortized ratably over a 5-year period, beginning with the midpoint of the tax year in which the specified R&E expenses were paid or incurred.[176] In addition, this is treated as a change in the taxpayer's accounting method under IRC §481 that is initiated by the taxpayer and made with the IRS's consent. If the expenses are incurred in tax years beginning after December 31, 2025, the provision is applied on a cut-off basis. That means that there would be no adjustment under IRC §481(a) for expenses paid or incurred in tax years that begin before 2026. Essentially, there is no change in the treatment of R&E expenditures until 2022.

Farming and Ranching Operations. Agricultural businesses deduct R&E expenditures every year. Farmers experiment with different chemicals and fertilizers, and the outcome depends upon weather, soil types, and hardiness of the plants. Expenses associated with product development activities can qualify as R&E expenditures, and they may also generate a research and development credit (discussed next).

Over the years, numerous products were created by innovations developed by a farmer or rancher. Expenses associated with innovative activities that develop a new business product are deductible R&E expenditures, even though the innovations provide future benefits. This also applies to activities that develop a new chemical that can be applied to seed or crops that enhance productivity. In short, due to the R&E expenditures, the farmer does not need to determine if the expense provides only a current benefit or a benefit that may last into the future.

RESEARCH AND DEVELOPMENT CREDIT

The Economic Recovery Tax Act of 1981 introduced the IRC §41 credit for increasing research activities. The credit is better known as the research and development (R&D) credit. The R&D credit is computed based upon qualified research expenditures. It is a general business credit, which reduces tax liability (rather than reducing taxable income), if allowed.[177] For a business with under $50 million in average annual gross receipts, the credit offsets both regular tax and AMT.[178]

For certain defined smaller businesses, the credit can offset the employer portion of SE taxes up to $250,000 (with some limitations).[179] The purpose of the credit as enacted remains the same today: to incentivize research and experimentation by providing a tax credit for activities that develop a new component of a taxpayer's business or improve an existing component's performance, functionality, reliability, or quality.[180]

176. TCJA §13206, amending IRC §174.

177. IRC §41.

178. 2018 Instructions for Form 6765, *Credit for Increasing Research Activities.*

179. IRC §41(h).

180. IRC §41(d)(3)(A).

Mechanics of the Credit

The R&D credit applies to activities (including research and software development) that develop a new business component or improve an existing component's performance, functionality, reliability, or quality.[181] A business component is defined as any product, process, computer software, technique, formula, or invention that is to be held for sale, lease, or license, or which is used by the taxpayer in the taxpayer's trade or business.[182] An activity qualifies for the credit by means of a 4-part test.[183]

1. The activity must develop or improve the functionality, quality, etc., of a business component.
2. The activity must rely on technological principles.
3. Substantially all of the activity must employ a process of experimentation that is designed to evaluate one or more alternatives.
4. The process of experimentation must be designed to eliminate uncertainty (regarding the company's capability, methodology, or appropriateness of design of a business component).

Expenses incurred with respect to a qualified activity are used to compute the R&D credit and are termed qualified research expenses (QRE). QRE can result from in-house activities as well as expenses incurred via contract. For an in-house activity, QRE includes W-2 wages paid to employees that are either directly involved in an activity (including research) that develops a new business component or supervises it or supports it. It also includes the cost of supplies and payments for qualified services (e.g., consultants and engineers).[184]

Note. Under certain federal farm programs, especially those programs designed to provide environmental benefits, the USDA shares part of the expense associated with complying with the program.[185] While the expense associated with establishing a conservation/environmental structure or program on the farm might otherwise qualify as a QRE, the portion that the government subsidizes under IRC §126 is not a QRE because the taxpayer did not incur the cost. In addition, as noted later, the expense is limited to a test plot rather than applying to expenditures incurred for the entire farm.

Once the qualified activities and QRE are determined, the credit is 6% of eligible expenses for each of the first three years that the taxpayer conducts qualified research activities.[186] After that, under the the alternative simplified method, the R&D credit is 14% of the excess of QRE for the tax year over 50% of the average QREs for the three preceding tax years and then multiplied by 65% (factoring in a reduction via IRC §280C).[187]

181. Treas. Reg. §1.41-4(a).
182. Treas. Reg. §1.41-4(b).
183. IRC §41(d).
184. IRC §41(b); see also *Suder v. Comm'r,* TC Memo 2014-201 (Oct. 1, 2014).
185. See, e.g., IRC §126.
186. IRC §41(c)(4)(B)(ii).
187. IRC §§41(c)(4) and 41(h).

Example 33. Bill tries to determine his R&D credit for 2018. He incurs the following QREs.

Year	Expense
2015	$50,000
2016	62,500
2017	75,000

The average over these three years is $62,500. Fifty percent of that 3-year average is $31,250. For 2018, he incurred $75,000 of QRE. From that amount, Bill subtracts 50% of the average QRE for the prior three years, or $31,250.

Next, the excess of QRE for 2018 over 50% of the average QREs for the three preceding tax years is multiplied by 14%, which is $6,125 (14% × ($75,000 – $31,250)). Then, $6,125 is multiplied by 65% (the IRC §280C credit reduction), which yields an R&D credit of $3,981.

The R&D credit is claimed on Form 6765, *Credit for Increasing Research Activities.* The associated instructions are instrumental in accurately computing the credit and completing Form 6765 properly.

If a farmer does not incur at least the level of QRE that Bill did in **Example 33,** it may not be worth the extra recordkeeping and tax preparation cost of claiming the credit.

Privately held businesses that are not C corporations that have $50 million or less in average gross receipts for the three preceding tax years can use the R&D credit to offset AMT.[188] Start-up companies, or those with less than $5 million in gross receipts for the current tax year and no gross receipts for the five preceding years, may use R&D credits against their payroll tax liability up to $250,000.[189]

Application to Agriculture

As noted above, the R&D credit applies incurred costs associated with research to develop new products or improve existing ones. It is important that the research involves technological information or some sort of application that is intended to develop new or improved business products or processes. It is also important that the research activities have a process of experimentation that relates to a new or improved function, performance, reliability, efficiency, or quality.

The types of research activities on a farm that generate qualified expenses for the R&D credit are those that are new to the farm and involve the testing of something before it can be used on a larger scale. For farmers, the credit could potentially have a wide application — farmers often are "tinkering" or investigating ways to improve productivity or efficiency of crop and/or livestock production. Common examples include the following.

- Testing new fungicides and seed treatment in an attempt to control insect disease
- Testing precision planting equipment to determine if it increases efficiency and/or yield
- Trying organic fertilizer
- Experimenting with a cover crop and its impact on soil fertility and soil erosion
- Trying new cultivation techniques such as strip tillage
- Experimenting with irrigation and drainage, and determining the impact on soil productivity and/or erosion
- Developing new weed/pest management techniques

188. Instructions for Form 6765, *Credit for Increasing Research Activities.*

189. IRC §41(h).

- Experimenting with crop genetics
- Testing various planting dates, plant population, and row spacing to determine the impact on plant growth and development
- Testing combines and other harvesting equipment to minimize crop waste and/or decrease harvest time
- Developing customized animal feed formulations
- Creating customized software
- Researching and designing new grain bins

The R&D credit can have broad application to many activities that occur on a farm or ranch. The IRS would likely argue that the qualified research activities (which give rise to QRE) must occur in a test plot, with expenses (including qualified wages and the cost of chemicals, fertilizer, seed, etc.) allocated to the specific area of the test plot. That allocation will result in a small number for most farmers, especially in the Midwest. Higher value crops, such as potatoes, onions, and fruits, might produce larger numbers. The QRE (and, hence, the R&D credit) must be associated with a test plot and not the entire farm.

DEDUCTIBILITY OF SOIL AND WATER CONSERVATION EXPENSES

Normally, land improvements constitute capital expenditures. The cost of land improvements is added to the basis of the land. Under IRC §175, a farmer can deduct the cost of certain improvements and soil and water conservation expenses in the first year in which the farmer incurs the expenditures.

If the deduction is not taken in that first year, this results in an election to **not** deduct. This election is binding in subsequent years. When this occurs, the expenditures increase the basis of the property to which they relate. Once a method of reporting such expenses is adopted, it must be followed in subsequent years unless the IRS agrees to a change.[190]

DEDUCTIBLE EXPENSES

Soil and water conservation expenses that qualify under the IRC §175 provision must be paid or incurred for soil or water conservation purposes with respect to land used in farming, or for the prevention of erosion on farmland.[191] Qualified expenses include the following types of expenditures for the treatment of earth moving on farmland used in the business of farming.[192]

- Leveling, conditioning, grading, terracing, and contour furrowing
- Control and protection of diversion channels, drainage ditches, irrigation ditches, earthen dams, water courses, outlets, and ponds
- Eradicating brush and planting windbreaks

Qualified expenses also include drainage district assessments (and soil and water conservation district assessments) if such assessments would have been a deductible expense if the taxpayer had paid them directly.[193]

190. IRC §175(e).
191. IRC §175(a).
192. IRC §175(c)(1).
193. IRC §175(c)(1)(B).

Deductibility Requirements

Several requirements must be met before soil and water conservation expenditures can be deducted. These include the following.

- The taxpayer must be engaged in farming.
- The land must be used in farming.
- The expenditures must be consistent with a conservation plan.
- The deduction cannot exceed 25% of gross income from farming.

Taxpayer Engaged in Farming. The taxpayer must be engaged in the business of farming. A farm operator or landowner receiving rental income under a material participation crop share or livestock share lease satisfies the test.[194] Under that type of lease, the landlord bears the risk of production and the risk of price change. A share lease in which the landlord reports the income from it on Form 4835, *Farm Rental Income and Expenses,* also satisfies the test. However, a cash lease does not meet the test. That type of arrangement is a rental activity.

Land Used in Farming. The expenditures must pertain to land used in farming to produce crops or sustain livestock. Specifically, the term "land used in farming" is defined as land used by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock.[195]

Improvements made to land that was not previously used in farming are not eligible. However, prior farming activity by a different taxpayer qualifies, as does using the land for a different type of agricultural activity.[196]

In addition, expenses associated with assets that qualify as deductible soil and water conservation expenses are not necessarily precluded from being depreciated by a subsequent purchaser of the real estate on which qualifying property has been placed. For example, in *Rudolph Investment Corp. v. Comm'r*,[197] the court allowed the taxpayer to depreciate earthen dams and earthen water storage tanks located on ranchland even though the structures qualified for a current deduction under IRC §175.

Consistent with a Conservation Plan. The expenditures must be consistent with a conservation plan approved by the Natural Resources Conservation Service (NRCS) or, if there are no NRCS plans for the area, a state (or local) plan.[198]

Expenditures for draining or filling wetlands or land preparation for center-pivot irrigation are not deductible as soil and water conservation expenses.[199] Similarly, expenses to clear land so that it can be farmed are not eligible and must be added to basis.

IRS Pub. 225, chapter 5, also explains that ineligible expenditures include those for various structures such as tanks, reservoirs, pipes, culverts, canals, dams, wells, or pumps composed of masonry, concrete, tile (including drainage tile), metal, or wood. The costs associated with these items are recovered through depreciation. Likewise, expenses that are currently deductible as repairs or are otherwise currently deductible under IRC §162 as ordinary and necessary business expenses are not claimed under IRC §175.[200]

194. Treas. Reg. §1.175-3.
195. IRC §175(c)(2).
196. Treas. Reg. §1.175-4(a).
197. *Rudolph Investment Corp. v. Comm'r,* TC Memo 1972-129 (Jun. 12, 1972).
198. IRC §175(c)(3). See also IRS Pub. 225, *Farmer's Tax Guide,* Ch. 5 (2016).
199. IRC §175(c)(3)(B).
200. Treas. Reg. §1.175-2(b)(2); IRC §175(c)(1)(B).

Deduction Limit. The deduction may not exceed 25% of the taxpayer's gross income derived from farming in any tax year.[201] The term gross income derived from farming includes gain from the sale of draft, dairy, breeding, or sporting purpose livestock, but not gains from the sale of machinery or land. Excess amounts may be carried over to succeeding years, subject to the same 25% limit.[202]

> **Note.** Qualified expenditures may be subject to the 25% limitation if the farm taxpayer defers a sufficient amount of grain sales, for example, such that gross farm income is decreased.

Claiming the Deduction

Soil and water conservation expenses are reported on Schedule F, line 12 ("conservation expenses"). As noted earlier, if they are not deducted, they must be added to the land's basis. The decision to either currently deduct or capitalize soil and water conservation expenses is made in the first year in which the expenses are incurred and establishes a method of accounting. IRS approval is required to change that method of accounting.

Recapture

If the taxpayer takes a deduction for soil and water conservation expenses on farmland or ranchland and disposes of the land within 10 years of its acquisition, part or all of the deductions are recaptured as ordinary income. The recapture amount includes the amount of gain on the disposition or the amount deducted multiplied by a percentage, whichever is lower.[203] The amount of recapture depends upon how long the land was held before disposition, as shown in the following table.

Year of Sale or Disposition	Recapture Percentage
1–5	100%
6	80%
7	60%
8	40%
9	20%
10	0%

The recaptured amount cannot exceed the amount of gain on the land.[204] If only a portion of the land is disposed of, the deductions attributable to the entire parcel are allocated to each part in proportion to the FMV of each at the time of disposition.[205] If disposition of the land is by gift, tax-free exchange, or transfer at death, no gain is recognized from recapture.[206]

> **Observation.** The current deduction for soil and water conservation expenses can be a helpful provision for many farmers. When a farmer has qualifying expenses, the deduction is a helpful tool to include in the tax planning arsenal.

201. IRC §175(b).
202. Treas. Reg. §1.175-5.
203. IRC §1252.
204. Ibid.
205. Treas. Reg. §1.1252-1(a)(4).
206. Treas. Reg. §1.1252-2(a).

AGRICULTURAL RULINGS AND CASES

Ltr. Rul. 201812003 (Dec. 15, 2017)
IRC §§1361 and 1362

☞ S Corporation Land Rents Not Passive; Trust Shareholder Was ESBT

Facts. The taxpayer, an S corporation engaged in farming and managing real property, had a grantor trust as a shareholder. The taxpayer engaged in four leases involving the farming operation that generated rental income to the taxpayer. The taxpayer sought a ruling on whether the taxpayer's rental income was passive investment income under IRC §1362(d)(3)(C), and whether the trust would qualify as an electing small business trust (ESBT) under IRC §1361(e).

The trust grantor died and the trust beneficiaries were two distributing trusts that are U.S. individuals and two tax-exempt organizations. Each beneficiary received a stepped-up basis under IRC §1014. Three of the leases provide that the taxpayer is a full participant in the farm's management, and that the tenant could not deviate from the managerial plan without the taxpayer's approval. The leases were crop-share leases that also split expenses between the taxpayer and the tenant. The fourth lease provided for the tenant's plowing, land clearing, and crop cultivation for a share of the crops.

Holding. The IRS determined that the taxpayer's rental income from the leases was not passive investment income under IRC §1362(d)(3)(C), and that the trust qualified as an ESBT because the beneficiaries were qualified beneficiaries and no interest of the trust was acquired by purchase.

***Alternative Carbon Resources, LLC v. U.S.*, No. 1:15-cv-00155-MMS; U.S. Court of Federal Claims (Mar. 22, 2018)**
IRC §6426

☞ Court Unfolds Refundable Fuel Credit Scam; 200% Penalty Applied

Facts. IRC §6426 provides for several alternative fuel credits. IRC §6426(d) specifies the details for the alternative fuel credit. The credit was enacted as part of the American Jobs Creation Act of 2004. That initial version provided credits for alcohol and biodiesel fuel mixtures. In 2005, Congress added credits to the Code for alternative fuels and alternative fuel mixtures.

The credits proved popular with taxpayers. During the first six months of 2009, more than $2.5 billion in cash payments were claimed for "liquid fuel derived from biomass." That is only one of the credits available, and the bulk of the $2.5 billion went to paper mills for the production of "black liquor" as a fuel source for their operations (which they had already been using for decades without a taxpayer subsidy). The IRS later decided that "black liquor" production was indeed entitled to the credit because the process resulted in a net production of energy.[207] However, later that year, new tax legislation retooled the statute and removed the production of "black liquor" from eligibility for the credit.

As modified, IRC §6426(d) (as of 2011) allowed for a $.50 credit for each gallon of alternative fuel that a taxpayer sold for use as a fuel in a motor vehicle or motorboat or sold by the taxpayer for use in aviation. In addition, an alternative fuel mixture credit of $.50 per gallon is allowed for alternative fuel that the taxpayer used in producing any alternative fuel mixture for sale or use in the taxpayer's trade or business.

207. CCM AM2010-001 (Mar. 12, 2010).

For purposes of IRC §6426, alternative fuel is **liquid fuel derived from biomass** as that phrase is defined in IRC §45K(c)(3).[208] **Liquid fuel** is not defined, but the U.S. Energy Information Administration defines the term as "combustible or energy-generating molecules that can be harnessed to create mechanical energy, usually producing kinetic energy [and that] must take the shape of their container." An **alternative fuel mixture** requires at least 0.1% (by volume) (i.e., one part per thousand) of taxable fuel to be mixed with an alternative fuel.[209] An alternative fuel mixture is "sold for use as a fuel" when the seller "has reason to believe that the mixture [would] be used as a fuel either by the person buying the mixture from the producer or by any later buyer of the mixture." In other words, a taxpayer could qualify for the alternative mixture fuel credit by blending liquid fuel derived from biomass and at least 0.1% diesel fuel into a mixture that was used or sold for use as a fuel, once the taxpayer properly registered with the IRS.[210]

In the case, an Iowa firm produced alternative fuel mixtures consisting of liquid fuel derived from biomass and diesel fuel. The plaintiff registered with the IRS and was designated as an alternative fueler that produces an alternative fuel mixture that is sold in the plaintiff's trade or business. The plaintiff's business model was structured around qualifying for and taking advantage of the taxpayer subsidy provided by the IRC §6426 refundable credit for alternative fuel production.

To produce alternative fuel mixtures, the plaintiff bought feedstock from a supplier. A trucking company picked up the feedstock and added the required amount of diesel fuel to create the alternative fuel mixture. The mixture was then delivered to a contracting party that would use the fuel in its business. The plaintiff entered into contracts with various parties that could use the alternative fuel mixture in their anaerobic digester systems to make biogas.

A contract with the Des Moines Wastewater Reclamation Authority (WRA) provided that the plaintiff would pay WRA to take the alternative fuel mixtures from the plaintiff. The plaintiff's consulting attorney (an energy tax credits "expert") advised the plaintiff that it would "look better" if the plaintiff charged "anything" for the fuel mixtures. Accordingly, the plaintiff charged the WRA $950 for the year for all deliveries. In return, the plaintiff was charged a $950 administrative fee for the same year. The WRA also charged the plaintiff a disposal fee of $.02634 per gallon for accepting up to 50,000 gallons per day of the alternative fuel mixtures.

The plaintiff treated the transfers of its alternative fuel mixtures as sales for "use as a fuel." That was in spite of the fact that the plaintiff paid the fee for the transaction. The plaintiff never requested a formal tax opinion from its expert. However, the expert advised the plaintiff that the transaction qualified as a sale, based upon an IRS private letter ruling to a different taxpayer involving a different set of facts and construing a different section of the Code. The expert did advise the plaintiff that an IRS inquiry could be expected, and that the transaction with the WRA amounted to a sale "regardless of who [paid] whom."

A few months later, the IRS issued a Chief Counsel Advisory indicating that if the alternative fuel was not consumed in the production of energy or did not produce energy, it would not qualify for the alternative fuel credit.[211] The expert contacted the IRS after the CCA was issued and then informed the plaintiff that the IRS might challenge any claim of the credit. The expert continued to maintain that the plaintiff's "qualification for tax credits…was straightforward."

The plaintiff claimed a refundable alternative fuel mixture credit in accordance with IRC §6426(e) of $19.8 million using Form 8849, *Claim for Refund of Excise Taxes.* The IRS initially allowed the credit for 2011, but upon audit the following year disallowed the credit and assessed a tax of $19.8 million in 2014. The IRS also assessed an excessive claim penalty of $39.5 million for claiming excessive fuel credits without reasonable cause,[212] an IRC §6663 civil fraud penalty, and IRC §6651 failure-to-file and failure-to-pay penalties.

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208. IRC §6426(d)(2)(G).

209. See Notice 2006-92, 2006-2 CB 774.

210. IRC 6426(a)(2).

211. CCA 201133010 (Jul. 12, 2011).

212. See IRC §6675.

Issue. The issue in this case is whether the plaintiff is entitled to the alternative fuel mixture credits.

Analysis. While the court noted that the plaintiff was registered with the IRS and produced a qualified fuel mixture, the court determined that the plaintiff did not sell an alternative fuel mixture for use as a fuel. The court noted that the term "use as a fuel" is not defined by the Code, but the court rejected the IRS's claim that the alternative fuel mixtures were not used as a fuel because the mixtures did not directly produce energy. Instead, they produced biogas that then produced energy, and the court noted that the IRS had previously issued Notice 2006-92 stating that an alternative fuel mixture is "used as a fuel" when it is consumed in the energy production process.

However, the court reasoned the "production of energy" requirement contained in the "use of a fuel" definition meant that the alternative fuel mixture that is sold must result in a net production of energy. As applied to the facts of the case, the WRA could not provide any data that showed which of the feedstock sources from its numerous suppliers was producing energy, and which was simply burned off and disposed of. As such, the plaintiff could not prove that its fuel mixtures resulted in any net energy production, and the "use as a fuel" requirement was not satisfied.

Even if the "use as a fuel" requirement was deemed satisfied, the court held that the plaintiff did not "sell" the alternative fuel mixture to customers. The nominal flat fee lacked economic substance. The court noted that the fee was "charged" only for the purpose of receiving the associated tax credit. In addition, no sales taxes were charged on the "sales." Thus, the plaintiff was not entitled to any alternative fuel mixture credits.

The court upheld the IRC §6675 200% penalty insomuch as the professional advice the plaintiff received was not reasonably relied upon. The court noted that the plaintiff's expert told the plaintiff that he was not fully informed of the plaintiff's production process and informed the plaintiff that he did not understand the anaerobic digestion process. In addition, while the plaintiff was informed that there had to be a net production of energy from its production process to be able to claim the credit, the plaintiff ignored that advice. Additionally, the court noted that the IRS private letter ruling that the expert based his opinion on involved a different statute, a distinguishable set of facts, and did not support the plaintiff's position. Likewise, a newly admitted local CPA that was hired to track feedstock received from suppliers and alternative fuel mixture deliveries for the plaintiff provided no substantive tax advice that the plaintiff could have relied upon.

Holding. The court ruled that the plaintiff had to repay the $19.8 million of claimed credits and pay an additional IRC §6675 penalty of $39.5 million. A large part of the other penalties were abated. The court noted that any portion of those penalties that was not abated may remain the plaintiff's liability.

On July 2, 2018, the court denied the plaintiff's motion to stay execution of judgment pending the outcome of its appeal.

***Wicks v. U.S.,* 304 F. Supp.3d 1079; U.S. District Court for the Northern District of Oklahoma (Jan. 22, 2018)**
IRC §183

☞ IRS Denied Summary Judgment on Hobby Loss Claim Against Cattle Operation

Facts. The plaintiff owned and operated a company that provided mechanical inspection services for major oil refineries and gas plants. Since 2006, the plaintiff had reported approximately $1 million of adjusted gross income on his tax return annually. He had an approximate net worth of $7 million. In addition to his business, the plaintiff built a cattle ranch in the late 1990s that he maintained as the sole owner and operator, performing all of the labor and spending three to four days weekly working on the ranching activity.

The cattle ranching activity never showed a year of profitability, with total gross receipts from 1997 through 2015 totaling $32,602 and net losses totaling $807,380. The plaintiff did not establish a written business plan or have any written financial projections. He did not use any accounting software or form a business entity for the cattle operation, although he did use a spreadsheet to track his expenses. He also did not market or promote the cattle operation, insure the herd against catastrophic loss, or consult a financial advisor.

Before 1997, the plaintiff's only experience with cattle was feeding and working them as a child. However, the plaintiff bought 80 acres of land containing a dilapidated barn and unusable fence, which he repaired. He purchased two longhorn heifers, built a new barn, bought an adjacent 180-acre tract to increase the herd to make the venture ultimately profitable, and improved the entire property by replacing fence, enlarging an existing pond, installing rural water, and constructing a cattle working facility and loafing shed. The plaintiff also consulted with a successful local rancher regarding profitable methods of cattle ranching. He purchased 20 cows to crossbreed in order to produce quality milk and beef, knowing that obtaining a crossbreed would take at least four years. The plaintiff purchased new hay baling equipment and feed bins. He sold cattle in 2013, after the cattle market rebounded from prior lows. The plaintiff attended seminars on cattle breeding and pasture management and read as much as he could about raising cattle. He joined two different state cattlemen's associations.

For 2010 and 2011, the IRS denied the loss deductions for the plaintiff's cattle ranching (and horse racing) activity, and assessed penalties. The total amount of tax and penalties (including interest) due was $89,838. The plaintiff paid the deficiency (plus interest) and sued for a refund, claiming that he engaged in the cattle ranching activity with profit intent as defined by Treas. Reg. §1.183-2(b). Later, at the plaintiff's request, the court dismissed the refund claim related to the horse racing activity. The IRS moved for summary judgment on the plaintiff's remaining claim related to the cattle ranching activity, arguing that the activity was not engaged in for profit and the resulting losses were nondeductible under the hobby loss rules of IRC §183.

On an evidentiary issue, the court allowed tax return information from post-2011 years into evidence because it was relevant in showing whether the plaintiff had a profit intent for the tax years in issue. The court denied the plaintiff's motion to include in evidence an affidavit containing factual statements the plaintiff made concerning the ranching activity that had not been made in previous filings or testimony. The court allowed into evidence testimony of an agricultural economist for the plaintiff to the extent the testimony related to economic conditions and their impact on the plaintiff's cattle ranching activity.

Issue. The issue in this case is whether the plaintiff engaged in the cattle ranching activity for profit.

Analysis. The court examined each of the nine factors in Treas. Reg. §1.183-2(b) in its analysis of the issue. These are summarized as follows.

1. **The manner in which the plaintiff carried on the activity —** The court determined that the fact that the plaintiff did not use sophisticated businesses practices weighed in the IRS's favor.

2. **The expertise of the taxpayer or his advisors —** The court determined that the factor was neutral. The plaintiff neither zealously pursued nor neglected chances to gain expertise in cattle ranching.

3. **The time and effort expended by the taxpayer in carrying on the activity —** The court noted that the plaintiff put in a substantial amount of time on the ranching activity without any substantial recreational benefit, which weighed in the plaintiff's favor.

4. **The expectation that assets used in the activity may appreciate in value —** The court noted that the plaintiff had a reasonable expectation that the capital improvements that he made to the land would appreciate in value.

5. **The success of the taxpayer in carrying on other activities —** The court noted that this factor was neutral. The court pointed out that the evidence showed that the plaintiff expended a substantial amount of time in the ranching activity, even though he did not operate it with great sophistication, and was successful in running a highly profitable mechanical inspection service business, which could provide an inference that he engaged in the cattle ranching activity with profit intent.

6. **The taxpayer's history of income or losses for the activity —** The many years of consecutive losses from the ranching activity weighed in the favor of the IRS.

7. **The amount of occasional profits, if any, which are earned —** The plaintiff never reported a profit from the activity. However, the court noted that this factor was mitigated to a degree by the fact that small farming operations are not generally lucrative.

8. **The taxpayer's financial status —** The court noted that the taxpayer was wealthy, which would allow him to participate in the cattle ranching activity without a profit intent.

9. **Elements of personal pleasure or recreation —** The IRS had not provided evidence that the plaintiff received any personal or recreational benefit from the ranching activity, which made it less likely that the plaintiff engaged in the activity without a profit intent. Thus, this factor weighed in the plaintiff's favor.

Holding. The court concluded that, based on the totality of the circumstances and viewing the evidence in the light most favorable to the plaintiff, a reasonable jury could conclude that, for 2010 and 2011, the plaintiff engaged in the cattle ranching activity with a profit intent. The court denied the IRS's motion for summary judgment. The court also denied summary judgment to the IRS on the penalty issue.

***Barnhart Ranch Co. v. Comm'r,* U.S. Court of Appeals, 5th Circuit; No. 16-60834 (Dec. 20, 2017)**
IRC §6662(a)

☞ Ranching Corporation Not Treated Separately From Owners, Resulting in Nondeductible Losses

7

Facts. The petitioners, two brothers, owned cattle, land, and oil operations in Texas. Their father had established a C corporation in the 1950s to pursue the various ranching and oil and gas operations. The corporation handled all of the sales, expenses, and payroll of the ranching and oil and gas activities. The petitioners inherited the business interests from their father upon his death. The petitioners also owned two ranches individually that they leased to the corporation and had numerous other oil and gas interests and real estate holdings that they owned together in partnerships, LLC, and other corporations.

The C corporation had 17 employees and held the employees' workers' compensation and employers' liability policies for the cattle operation and bought farm and ranch insurance in the corporate name. The corporation was the record owner of various farming/ranching assets. Under the corporation's "joint interest accounting system," which the petitioners' counsel testified at trial was common in the oil and gas industry, the corporation accounted for all of the income and expense and then, on a monthly basis, wrote a check to each brother for his half share of the corporation's net income. If there was a loss for a month, the brothers wrote a check to the corporation.

The corporation experienced losses for 2010–2012 and reported no gross receipts or taxable income for 2012–2013. The petitioners reported 6-figure losses on their Schedules C derived from the cattle operation.

In a 2014 audit of the 2010–2012 tax years, the IRS determined that the cattle losses should have been reported by the corporation (where the losses were not deductible), rather than on the petitioners' personal returns. The IRS also determined that penalties under IRC §6662(a) applied. The total tax deficiency and penalties asserted by the IRS exceeded $1 million. The Tax Court affirmed the IRS's position.

Issue. The issue in this case is whether the Tax Court erred in its assessment of deficiencies and penalties against the petitioners.

Analysis. The appellate court rejected the petitioners' agency argument under which they claimed that the C corporation acted as their agent by merely holding title to assets for the petitioners who owned the assets and ran the operation. They claimed that the corporation was merely an accounting entity that acted on behalf of the petitioners rather than on its own behalf. The petitioners claimed that the corporation was simply the "manager" of the operation. However, the appellate court disagreed.

The appellate court noted that the petitioners failed to provide the Tax Court with their "controlling law" cases for the proposition that cattle ownership is not relinquished when another entity manages the daily cattle operations. In addition, the appellate court noted that the petitioners had not argued their "manager" theory (based on *Jones Livestock Feeding Co.*[213]) at the Tax Court and had waived the argument. The appellate court noted that the petitioners' "agency" argument and "manager" argument were fundamentally different.

The appellate court, agreeing with the Tax Court, noted that all ranching operations were conducted by the corporation and the corporation publicly appeared to be conducting all the business activity, not the petitioners individually. Consequently, all of the income and loss of the ranching and oil/gas activity should have been reported at the corporate level, where the losses were not deductible. The appellate court upheld the IRS-imposed accuracy-related penalties, which exceeded $200,000. The appellate court noted that the petitioners' "substantial authority" for reporting the ranching transactions in the manner that they did was based on their theory that the corporation was the "manager" of the operations. However, that argument was not raised at the Tax Court and was deemed waived. The petitioners did not present the Tax Court with any authority for their tax reporting position.

The petitioners had represented themselves as "savvy" businessmen who were experienced in complex business entities, but they did not try to determine the correctness of their income tax reporting. Therefore, the Tax Court ruled properly in rejecting the petitioners' good-faith and reasonable-cause defenses even though they were consistent in their accounting and tax reporting for numerous years.

Holding. The court affirmed the Tax Court ruling. Thus, the appellate court held that the Tax Court's determination of negligence was proper. The appellate court also held that the Tax Court did not err in determining that the petitioners lacked reasonable cause for the manner in which they reported their income. Therefore, the assessment of deficiencies and penalties was proper.

***Welch v. Comm'r,* TC Memo 2017-229 (Nov. 20, 2017)**
IRC §183

☞ Ranching Activity Not a Hobby

Facts. The petitioner, confined to a wheelchair since his freshman year of college, went on to obtain his Ph.D. and taught at several universities over a 40-year span. In the 1970s, he founded a consulting business. In the early 1980s, he formed another business that provided software to researchers and developed a statistical program in 2007 to assist businesses in their hiring practices.

In 1987, he purchased 130 acres that would become Center Ranch. The petitioner's original intent was to grow hay as a cash crop and to raise some cattle on these acres. The petitioner grew the ranch to 8,700 acres composed of seven tracts and various divisions. The headquarters of the ranch contained two duplexes on 20 acres that were used to house ranch hands when needed and were leased out when the ranch hands were not needed. The ranch had 25 full-time employees who received annual salaries ranging from $25,000 to $115,000.

Center Ranch also had a vet clinic that provided services for large and small animals. Construction on the vet clinic began in 2003. It was originally built to support Center Ranch's horse operation. All of the vet clinic's employees, except the veterinarians, were Center Ranch employees. There was a licensed veterinarian on site during each of the years in issue. The petitioner rented the vet clinic facilities to the veterinarians and had management services agreements and licensing agreements with them. The vet clinic provided services for Center Ranch animals under the management services agreements. It provided services for animals owned by the public for a fee. The vet clinic was a separate entity and filed its own tax returns for the years in issue.

The ranch also had a trucking operation. It owned numerous 18-wheel trucks that were used to move cattle and hay around the ranch, to transport cattle to and from market, and to perform backhauls.

213. *Jones Livestock Feeding Co. v. Comm'r,* TC Memo 1967-57 (Mar. 27, 1967).

The ranch conducted timber operations and employed a timber manager. The petitioner subscribed to numerous professional publications.

The petitioner changed the type of cattle that the ranch raised to increase profitability, steadily increasing herd size. The hay operation was modified to maximize profitability due to weather issues. The ranch built its own feed mill that was used for chopping and drying stored hay.

In 2003, the petitioner began construction of a horse center as part of the ranch headquarters, including a breeding facility that operated in tandem with the veterinary clinic. Ultimately, the petitioner's horses were entered in cutting competitions, with winnings increasing annually from 2007 to 2010.

The IRS issued notices of deficiency for 2007–2010. For the years at issue, the petitioner had total losses of approximately $15 million and gross income of approximately $7 million. For those years, the petitioner's primary expense was depreciation. The IRS claimed that the ranching activity was not engaged in for profit and the expenses were deductible only to the extent of income.

Issue. The issue in this case is whether the petitioner's ranching activity was engaged in for profit.

Analysis. The Tax Court determined that all the petitioner's activities were economically intertwined and constituted a single ranching activity. On the profit issue, the court determined that none of the factors in Treas. Reg. §1.183-2(b) strongly favored the IRS. The relevant factors included the following.

- The IRS claimed that mistakes in the petitioner's books and records were highly relevant, but the court disagreed, noting that some mistakes on the books and records of a multi-million-dollar activity do not negate that the activity was carried on in a business-like manner.
- The court noted that the ranch and the petitioner had separate bank accounts.
- The court observed that the petitioner made changes in the activity upon realizing that certain aspects of the ranch were not profitable.
- The operation paid ranch hands when needed and paid some of its employees more than median wages in the area so as to attract the best managers and employees.
- The court noted that the petitioner had been involved in agriculture for practically all of his life and that his time spent on weekends at the ranch and daily communications with ranch managers was sufficient to show a profit intent.
- The court determined that the petitioner showed that he expected the ranch assets to appreciate in value and that the IRS argument that the assets would not appreciate as much as the petitioner and his experts claimed they would was inadequate. The court disagreed with the IRS's argument that the petitioner must have a profit motive that expects recoupment of all of the ranch's past losses.
- While the court found the ranch's history of income and losses and the amount of occasional profits, if any, favored the IRS, the court did not give these factors much weight because the cattle and horse operations were in their startup phases during the years in issue.
- The petitioner's financial status and whether elements of personal pleasure or recreation were present were held to be neutral factors. The court noted that the petitioner had invested over $9 million of his own funds into the ranch and had been in a wheelchair since college, which restricted his ability to derive personal pleasure from the ranch.

Holding. The court held that the petitioner's ranching activity was conducted for profit and the losses were fully deductible. The court specifically rejected the IRS's argument that a profit motive could not be present when millions of dollars of losses were generated.

CCA 201733013 (Jul. 12, 2017)
IRC §§6031 and 6698

☞ No Exception from Filing a Partnership Return

Facts. On a question raised by an IRS senior technician reviewer, the IRS Chief Counsel's Office stated that Rev. Proc. 84-35[214] does not provide an automatic exemption from the requirement to file Form 1065, *U.S. Return of Partnership Income.* Under Rev. Proc. 84-35, the IRS noted that domestic partnerships with 10 or fewer partners that fall within the IRC §6231(a)(1)(B) exceptions are deemed to meet the reasonable cause test and are not liable for the IRC §6698 penalty.

Analysis. The IRS explained that IRC §6031 requires partnerships to file Form 1065 each tax year and that failing to file is subject to penalties under IRC §6698 unless the failure to file is due to reasonable cause. Neither IRC §6031 nor IRC §6698 contain an automatic exception to the general filing requirement of IRC §6031(a) for a partnership as defined in IRC §761(a).

The IRS noted that it cannot determine whether a partnership meets the reasonable cause criteria or qualifies for relief under Rev. Proc. 84-35 unless the partnership files Form 1065 or some other document. The IRS also noted that the returns of partners are not linked together during initial processing, and the IRS does not know the number of partners in the partnership or whether the partners timely filed individual income tax returns until either a partner or the partnership is audited.

The reasonable cause requirement can be met, the IRS noted, if the partnership or any of the partners establishes (if required by the IRS) that all partners have fully reported their shares of the income, deductions, and credits of the partnership on their timely filed income tax returns. Reasonable cause under Rev. Proc. 84-35 is determined on a case-by-case basis and IRM Section 20.1.2.3.3.1 sets forth the procedures for applying the guidance of Rev. Proc. 84-35.

Holding. Rev. Proc. 84-35 does not provide an automatic exemption to partnerships from the requirement to file Form 1065.

Rutkoske, et al. v. Comm'r, **149 TC No. 6 (Aug. 7, 2017)**
IRC §§170 and 2032A

☞ "Qualified Farmer" Defined for Conservation Easement Donation Purposes

Facts. This case involved a limited liability company (LLC) that owned various tracts of land that it leased to a farming general partnership. Two brothers owned the LLC equally and also had ownership interests in the farming general partnership along with other farming entities. The complex structure was established for the purported reason of maximizing farm program payment limitations.

In 2009, the LLC conveyed a conservation easement on a 355-acre tract to a land conservancy on the east coast. The conservancy was a qualified charity under IRC §501(c)(3) that could receive the conveyance and allow the donors a charitable deduction. The conveyance placed development restrictions on the property in exchange for $1.5 million. A simultaneous appraisal valued the property without the easement restriction at $4.97 million and at $2.13 million with the development restrictions. The claimed conservation contribution deduction was $1.34 million, which the brothers split evenly between them on their individual returns in accordance with IRC §§702(a)(4), 702(b), and 703(a) and Treas. Reg. §1.703-1(a)(2)(iv).

214. Rev. Proc. 84-35, 1984-1 CB 509.

The LLC then sold its interest in the tract to a third party for $2.0 million. The charitable contribution deduction of $1.34 million was computed by taking the difference between the pre- and post-easement restriction value of the property ($2.84 million) and subtracting the payment received for the conveyance ($1.5 million). The brothers claimed the deduction at 100% of their contribution base. The IRS disagreed, claiming that the deduction was limited to only 50% of their contribution base (i.e., their adjusted gross income).

Each brother, on their respective 2009 returns, claimed a charitable contribution deduction attributable to the easement of $667,520 along with their respective shares of long-term capital gain from the sale of the LLC's interest in the tract to the third party, which was approximately $900,000 each. Each brother had a small amount of wage income. They also had a small amount of interest income and approximately $200,000 of losses from partnerships and S corporations. They claimed that their respective share of proceeds from the sale of the tract to the third party and the proceeds from the sale of the development rights constituted farm income within the definition of IRC §2032A(e)(5). Accordingly, they asserted that their farm income exceeded the 50% mark, entitling each of them to a 100% of contribution base deduction for the conservation easement donation. They argued that farming requires investment in physical capital such as land and, as an integral asset to the farming operation, the sale proceeds of the 355-acre tract counted as farm income. The IRS disagreed based on a strict reading of IRC §2032A(e)(5), as applied to IRC §170(b)(1)(E)(v).

Issue. The issue is whether the brothers were qualified farmers at the time they conveyed a conservation easement.

Analysis. Under IRC §170, a taxpayer can claim a charitable deduction for a qualified conservation contribution to a qualified charity. The amount of the deduction is generally limited to 50% of the taxpayer's contribution base (adjusted gross income (AGI) computed without regard to any NOL for the year, less the amount of any other charitable contributions for the year).[215] Any amount that cannot be deducted because of the limitation can be carried forward to each of the next five years, subject to the same 50% limitation in each carryforward year.[216]

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For a taxpayer who is a "qualified farmer or rancher" for the tax year of the contribution, the limit is 100% of the taxpayer's contribution base, with a 15-year carryforward provision applying. A "qualified farmer or rancher" is a taxpayer whose gross income from the trade or business of farming exceeds 50% of the taxpayer's gross income (all income from whatever source derived, except as otherwise provided) for the tax year.[217] Income from farming does not include income derived from hunting and fishing activities[218] or from the sale of a conservation easement.[219] However, the income from hunting, fishing, and sale of a conservation easement is included in the taxpayer's gross income.[220] Income from timber sales is included in both computations.[221]

Income from the trade or business of farming includes "…cultivating the soil or raising or harvesting any agricultural or horticultural commodity…on a farm; handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than half of the commodity so treated; and … planting, cultivating, caring for, or cutting of trees, or the preparation…of trees for market."[222]

215. IRC §170(b)(1)(G).

216. IRC §170(d)(1).

217. IRC §170(b)(1)(E)(v); IRS Notice 2007-50, 2007-1 CB 1430, Q&A No. 4.

218. IRS Notice 2007-50, 2007-1 CB 1430, Q&A No. 8.

219. IRS Notice 2007-50, 2007-1 CB 1430, Q&A No. 6.

220. IRS Notice 2007-50, 2007-1 CB 1430, Q&A Nos. 6 and 8.

221. IRS Notice 2007-50, 2007-1 CB 1430, Q&A No. 7.

222. IRC §§2032A(e)(5)(A)–(C)(ii).

The contributed property need not be actually used or available for use in crop or livestock production to allow the donor to claim a deduction for the full value, but the property must be subject to a restriction that it remain available for use in either crop or livestock production.[223] Property used or available for use in crop or livestock production consists of the entire property, including any improvements.[224]

The Tax Court said that IRC §170(b)(1)(E) was "narrowly tailored" to provide a tax benefit to a qualified farmer, which had a specific definition that they would not broaden. The Tax Court determined that the LLC structure disqualified the brothers because the character of the deduction flowed through to them from the LLC, and the LLC was not in the business of farming. Instead, the Tax Court noted, the LLC was engaged in the business of leasing land.

Note. On this point, the Tax Court is arguably incorrect (and did not need to make the statement; it was unnecessary as to the outcome of the case). As the Tax Court noted, the contribution itself was properly claimed by each brother at the individual level on their respective returns. Each brother used the 355-acre tract in their farming business. Partnerships do not pay tax and should be viewed under the aggregate theory. Indeed, the IRS stated in 2007 that, when a qualified conservation contribution is made by a pass-through entity (such as a partnership or S corporation), the determination of whether an individual who is a partner or shareholder is a qualified farmer for the tax year of the contribution is made at the partner or shareholder level.[225] The Tax Court made no reference to the 2007 IRS statement.

Note. A pass-through entity that owns land on which a conservation easement is conveyed to a charity must be engaged in the trade or business of agriculture. When a pass-through entity is involved, the computation of the taxpayer's true gross income must include all of the pass-through income from farming activities and nonfarming activities. In this case, it does not appear that the Tax Court took that into account (even though it would not have made a difference in the outcome of the case).

From purely a tax planning standpoint, assuming the LLC was engaged in the trade or business of farming, the land sale income would have still presented a problem for the brothers in reaching the 50% gross income threshold. To deal with that problem, structuring both the conveyance of the conservation easement and the LLC's sale of its remaining interest as an installment sale with the reporting of the gain in the tax year after the tax year of the contribution would have allowed the brothers to meet the 50% test.

From a broader, more general perspective, the 100% of contribution base limit can work against a qualified farm taxpayer. For instance, if a qualified farmer's contribution exceeds the farmer's AGI, some of the tax savings of the contribution is realized at the lower tax rates (10% and 15% in 2017). In addition, the charitable contribution can have the effect of eliminating all of the taxpayer's taxable income. Consequently, if the taxpayer has other Schedule A itemized deductions, they, along with the taxpayer's personal exemptions, do not produce any tax benefit. The statute does not provide any way for the qualified farmer to decline the 100% of contribution base limit and fall back to the 50% level. In certain situations, it might be better from a tax standpoint for a qualified farmer to make a qualified contribution in a year when they do not meet the 50% test.

223. IRC §170(b)(1)(E)(iv)(II).

224. IRS Notice 2007-50, 2007-1 CB 1430, Q&A No. 11. See also Treas. Reg. §1.170A-14(f), Example 5.

225. IRS Notice 2007-50, 2007-1 CB 1430, Q&A No. 5.

Holding. The Tax Court upheld the IRS determination. Neither brother was a **qualified** farmer, although each one was (as the Tax Court noted) unquestionably a farmer. The Tax Court held that the income from the sale of the property was not farm income. The Tax Court reached the same conclusion as to the income from the sale of the development rights. The income from those sales was not specifically enumerated in IRC §2032A(e)(5) and did not fit within the same category of activities enumerated in that provision.

Observation. The *Rutkoske* decision illustrates a significant limitation for farmers — it is very difficult to get a 100% of AGI deduction (as a "qualified farmer") when property is disposed of at a gain in the same year in which a conservation easement is donated unless an installment sale is structured. Entity structuring for USDA farm program payment limitation purposes can work to eliminate the deduction in its entirety. Attorneys familiar with USDA farm program payment limitation rules are often not well-versed in farm taxation, and that can be the case even if they anticipate that a client might make a conservation easement donation.

***Robison v. Comm'r*, TC Memo 2018-88 (Jun. 19, 2018)**
IRC §§183 and 469

☞ Ranching Activity Had Profit Motive, But Was Passive

Facts. The petitioners, a married couple, worked for a technology company in the San Francisco Bay area. During the years in issue, 2010–2014, the husband's salary ranged from $1.4 million to $10.5 million. He also was an executive vice president of Hewlett-Packard Co.

In 1999, the petitioners bought a 410-acre tract in Utah for $2 million. They later acquired additional land, bringing their total land holdings to over 500 acres. After refurbishing the property, they hired a full-time manager to operate the ranch. However, the plaintiffs never showed a profit from their "ranching" activity. They showed losses ranging from slightly under $200,000 to nearly $750,000 every year. The petitioners deducted the losses, which the IRS disallowed.

Issues. The issues in this case are as follows.

- Whether the petitioners were engaged in a ranching activity with the objective of making a profit
- Whether the petitioners materially participated in the ranching activity

Analysis. The Tax Court applied the 9-factor test of Treas. Reg. §1.183-2(b) and determined that the petitioners **did** have a profit motive. However, the employment of a ranch manager indicated to the Tax Court that the petitioners might be engaged in a passive activity subject to the passive loss rules of IRC §469.

Temp. Treas. Reg. §1.469-5T(a) contains seven tests that are used to determine whether a taxpayer materially participates in the activity on a basis that was regular, continuous, and substantial. A taxpayer can establish material participation by satisfying any one of these seven tests. The Tax Court determined that only two were relevant in this case: the 500-hour test and the facts and circumstances test. The petitioners prepared logs showing that they devoted more than 500 hours to the activity during the years in issue, but the logs were prepared after the fact in preparation for trial. The Tax Court determined that "a very significant portion" of the hours the petitioners spent on the activity were as investors rather than as material participants.

In addition, the presence of the paid manager disqualified the hours the petitioners devoted to management activities from counting towards their participation. Accordingly, the Tax Court determined that the 500-hour test had not been satisfied. The presence of the manager also meant that the petitioners could not satisfy the facts and circumstances test.

Holding. The court held that the petitioners were entitled to claim the deductions for the losses from the ranching activity because they did have a profit motive. However, the petitioners did not materially participate in the ranching activity. Accordingly, the passive loss limitations apply, and the deductions were suspended until years in which the petitioners show a profit from the activity.

Note. If the taxpayers show a profit in subsequent years, the suspended loss deductions will be limited to the profit from the activity. If they never show a profit, the losses can be deducted upon sale of the activity.