Chapter 6: Agricultural Issues and Rural Investments

6

Please note. Corrections were made to this workbook through January of 2020. 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.

About the Author

Roger McEowen, JD, is the Kansas Farm Bureau Professor of Agricultural Law and Taxation at Washburn University School of Law in Topeka, Kansas. He is a published author and prominent speaker, conducting more than 80 seminars annually across the United States for farmers, agricultural business professionals, lawyers, and tax professionals. He can also be heard on WIBW radio and RFD-TV. His writing can be found in national agriculture publications, a monthly publication, *Kansas Farm and Estate Law,* his two books, *Principles of Agricultural Law* and *Agricultural Law in a Nutshell,* as well as on **www.washburnlaw.edu/waltr.** He received a B.S. with distinction from Purdue University in Management in 1986, an M.S. in Agricultural Economics from Iowa State University in 1990, and a J.D. from the Drake University School of Law in 1991. He is a member of the Iowa and Kansas Bar Associations and is admitted to practice in Nebraska. He is also a past President of the American Agricultural Law Association.

Other chapter contributors and reviewers are listed at the front of this volume.

QBID AND AGRICULTURAL COOPERATIVES

OVERVIEW

In March 2018, President Trump signed into law the Consolidated Appropriations Act, 2018 (Act).[1] The Act includes a provision modifying IRC §199A,[2] which was included in the Tax Cuts and Jobs Act (TCJA) enacted in December 2017 and which became effective for tax years beginning after 2017. IRC §199A provides a 20% deduction for sole proprietorships and pass-through businesses, which is named the qualified business income deduction (QBID). The provision created a tax advantage for sellers of agricultural products sold to agricultural cooperatives. Before the technical correction, those sales generated a 20% deduction applied to **gross** sales for the seller. However, if those same agricultural goods were sold to a company that was not an agricultural cooperative, the 20% deduction could only be applied to **net** business income. That tax advantage for sales to cooperatives was deemed a drafting error and has now been technically corrected.

The modified provision removes the TCJA's QBID provision for agricultural cooperatives and replaces it with the domestic production activities deduction (DPAD), which was available under IRC §199 before 2018.[3] In addition, the TCJA provision that created a 20% deduction for **patronage dividends** was eliminated. Moreover, the modified language limits the QBID to 20% of farmers' net income, excluding capital gains.

THE MODIFICATION: NEW IRC §199A(g)[4]

The Act eliminates the QBID for agricultural or horticultural cooperatives. In its place, the former DPAD provision is essentially restored for such cooperatives. Thus, an agricultural cooperative can claim a deduction from taxable income equal to 9% of the lesser of the following.[5]

- The cooperative's qualified production activities income (QPAI)
- Taxable income, determined without regard to either of the following
  - The cooperative's §199A(g) deduction
  - Any deduction allowable under IRC §§1382(b) and (c) (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions) for the tax year.

The amount of the deduction for a tax year is limited to 50% of the Form W-2, *Wage and Tax Statement,* wages paid by the cooperative during the calendar year that ends in such tax year.[6] For this purpose, W-2 wages are determined in the same manner as under the §199A QBID provisions (which is not repealed for noncooperatives), except that "wages" does not include any amount that is not properly allocable to domestic production gross receipts. A cooperative's DPAD is reduced by any amount passed through to patrons.[7]

> **Note.** For information about the definition of "wages" under §199A and other QBID provisions, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: QBID Update.

---

1. PL 115-141.
2. PL 115-141, Division T.
3. Ibid.
4. Ibid.
5. IRC §199A(g)(1)(A).
6. IRC §199A(g)(1)(B)(i).
7. IRC §199A(g)(1)(B)(ii).

Under the technical correction, the definition of a "specified agricultural or horticultural cooperative" is limited to organizations to which part I of subchapter T applies[8] that either:

- Manufacture, produce, grow, or extract in whole or significant part any agricultural or horticultural product; or
- Market any agricultural or horticultural product that their patrons have manufactured, produced, grown, or extracted in whole or significant part.[9]

The technical correction notes that Treas. Reg. §1.199-6(f) applies such that agricultural or horticultural products also include fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production that are manufactured, produced, grown, or extracted by the cooperative.

Note. As modified, a "specified agricultural or horticultural cooperative" does not include a cooperative **solely** engaged in the provision of supplies, equipment, or services to farmers or other specified agricultural or horticultural cooperatives.[10]

Impact on Patrons[11]

Under the revised provision, an eligible patron who receives a **qualified payment** (defined later) from a specified agricultural or horticultural cooperative can claim a deduction in the tax year of receipt. This deduction amount is equal to the portion of the cooperative's deduction for QPAI that meets both of the following conditions.

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

Note. The cooperative's §199A(g) 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.[12]

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 §199A(a)).[13]

Qualified Payment. A qualified payment is any amount that meets all three of the following conditions.

1. The payment must be either a patronage dividend or a per-unit retain allocation.[14]
2. The payment, must be received by an eligible patron from a qualified agricultural or horticultural cooperative.[15]
3. The payment must be attributable to QPAI with respect to which a deduction is allowed to the cooperative.[16]

---

8. Part I of Subchapter T of the Code (IRC §§1381–1383) contains the law dealing with the tax treatment of cooperatives.
9. IRC §199A(g)(4)(A).
10. IRC §199A(b)(7), replacing former §199A(g)(3)(C).
11. IRC §199A(g)(2)(A).
12. IRC §199A(g)(5)(A)(iv).
13. IRC §199A(g)(2)(B).
14. IRC §199A(g)(2)(E)(i).
15. IRC §199A(g)(2)(E)(ii).
16. IRC §199A(g)(2)(E)(iii).

An eligible patron cannot be a C corporation and cannot be another agricultural cooperative.[17] In addition, a cooperative cannot reduce its income under IRC §1382 for any deduction allowable to its patrons by virtue of §199A(g).[18] 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.

Transition Rule. Under a transition rule, the repeal of the DPAD does not affect a qualified payment a patron receives from an agricultural cooperative in a tax year beginning after 2017. This applies as long as the payment is attributable to QPAI and the deduction was allowed to the cooperative under the former DPAD provision in a tax year that began before 2018.[19] That type of qualified payment is subject to the pre-2018 DPAD provision. Any deduction allocated by a cooperative to patrons connected to that type of payment can be deducted by patrons in accordance with the pre-2018 DPAD rules.[20] In that event, no post-2017 QBID is allowed for that type of qualified payments. This statement created surprising results and added complexity to the computations for determining the proper 2018 QBID. To properly compute their 2018 QBID, taxpayers needed to identify sales to noncooperatives, sales to cooperatives during the year that began in 2017, and sales to cooperatives during the year that began in 2018.

CURRENT STATUS OF AGRICULTURAL COOPERATIVES AND PATRONS

The technical correction to §199A affects farmers in several ways, including the following.

- The overall QBID cannot exceed 20% of taxable income less capital gain. That restriction applies to all taxpayers regardless of income. When income exceeds the taxable income threshold, the 50% of W-2 wages/qualified property limit is phased in.[21]

  Unlike 2018 when there were two taxable income limitations, ($315,000 for married filing jointly (MFJ) taxpayers and $157,500 for all others),[22] the 2019 inflation adjustments resulted in three taxable income limitations, as shown in the following table.[23]

Married filing jointly (MFJ)	$321,400
Married filing separately (MFS)	160,725
Single/Head of household	160,700

Observation. It is worth noting that, while the 2018 taxable income limitations corresponded to income tax brackets, the 2019 taxable income limitations do not correspond directly to the tax brackets.[24]

Note. For information about the qualified property limit and other QBID provisions, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: QBID Update.

17. IRC §199A(g)(2)(D).
18. IRC §199A(g)(1)(C).
19. PL 115-141, Div. T, §101(c).
20. Treas. Reg. §1.199A-7(h).
21. IRC §§199A(a)(1), 199A(a)(2).
22. IRC §199A(e)(2)(A).
23. In accordance with Rev. Proc. 2018-57, 2018-49 IRB 827 and IRC §199A(e)(2).
24. Rev. Proc. 2018-57, 2018-49 IRB 827.

- The prior §199 DPAD no longer exists, except as resurrected for agricultural and horticultural cooperatives (as noted previously). The §199A QBID is available for sole proprietorships and pass-through businesses.[25] For farming businesses structured as a sole proprietorship or pass-through entity, the tax benefit of the 20% QBID likely outweighs the result that the DPAD would have produced.
- C corporations cannot claim a QBID,[26] and the corporate tax rate is now a flat 21%.[27] That represents a tax increase for those corporations that would have otherwise been subject to a 15% rate under prior law and benefitted from the DPAD in prior years.
- The cooperative's DPAD does not pass through to patrons that are C corporations.[28]
- For a farmer who files Schedule F, *Profit or Loss From Farming,* is a patron of an agricultural cooperative, and pays no wages, there are two steps to calculate the tax benefits derived from §199A. First, the cooperative's DPAD that is passed through to the patron can be applied to offset the patron's taxable income regardless of source. Second, the farmer/patron is entitled to a QBID equal to 20% of **net** farm income derived from qualified **noncooperative** sales, subject to the taxable income limitation.[29]
- For farmers who pay W-2 wages and sell to agricultural cooperatives, the QBID on the sales to cooperatives is limited to the lesser of 50% of W-2 wages or 9% of QBI attributable to the income from the cooperative.[30] Thus, for a farmer who has farm income below the taxable income limitation threshold, the QBID is never less than 11% (i.e., 20% QBID less 9% DPAD). If the farmer is above the taxable income limitation threshold, the 50% of W-2 wages limit is applied before the 9% limit. The result is the farmer's QBID, which cannot exceed 20% of taxable income. Any pass-through DPAD from the cooperative is added to this amount to produce the total deductible amount.[31]

Note. For information about the taxable income limitation and other QBID provisions, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: QBID Update.

- For farmers who sell agricultural products to noncooperatives and pay W-2 wages, a QBID of 20% of net farm income is available. If the farmer's taxable income is less than net farm income, the deduction is 20% of taxable income less capital gains. If net farm income exceeds the taxable income limitation, the QBID may be reduced on a phased-in basis.[32]
- The newly retooled cooperative DPAD of §199A may provide incentive for more cooperatives to pass the DPAD through to their patrons.

25. IRC §199A(c)(1).
26. IRC §199A(a).
27. PL 115-97.
28. IRC §199A(g)(2)(D)(i).
29. IRC §199A(a).
30. IRC §199A(g)(1).
31. IRC §199A(g)(1)(B)(i).
32. IRC §199A(a).

2018 TAX SEASON EXPERIENCE

The Act[33] requires separate computations of qualified business income (QBI) for income received based on the fiscal year of the cooperative. As a result, for many cooperative patrons, the DPAD as formulated under the former §199 was involved along with the QBID under §199A. This means it was possible that three forms of the DPAD could have been used for 2018 returns: a transition DPAD; a DPAD from a fiscal year pass-through entity; and a cooperative DPAD based on §199A.

Transition DPAD Notices

In 2018, some cooperatives distributed transition DPAD notices relating to income for the cooperative's fiscal year ending in 2018. As mentioned earlier, the §199 DPAD is temporary and is limited to QPAI generated by a cooperative in the cooperative's year beginning before January 1, 2018. The DPAD amount is reported on line 23 of Form 8903, *Domestic Production Activities Deduction.* This amount is then subtracted as an additional adjustment to income on Schedule 1 (Form 1040), *Additional Income and Adjustments to Income,* line 36 (2018 Schedule 1). The taxpayer is instructed to write "DPAD" on the dotted line next to the amount.[34]

Practitioner Planning Tip

Farmers who are members or shareholders in a fiscal year pass-through entity may benefit from both the §199 DPAD and the §199A QBID for income from the entire fiscal year.

The Act allows cooperatives to continue to compute a DPAD under §199A(g) ("co-op DPAD"). The cooperative may pass some, all, or none of the co-op DPAD to the patrons. In accordance with Form 1040 instructions, patrons were required to report co-op DPAD by attaching a statement to the return titled "DPAD 199A(g)" and to reduce the amount of taxable income they entered on line 10 of Form 1040 by the amount of their deduction.

Unfortunately, the IRS computers did not recognize the forms as submitted in accordance with the instructions. Line 10 of the 2018 Form 1040, *U.S. Individual Income Tax Return,* is taxable income, which is determined by subtracting lines 8 and 9 from line 7 (adjusted gross income (AGI)). However, as noted above, the §199A(g) co-op DPAD is not reflected in lines 7, 8, or 9. Therefore, it appears that line 10 is not calculated correctly even though the form has been completed in accordance with the IRS instructions.

Observation. Taxpayers reported receiving CP11T Notices from the IRS that effectively ignored the co-op DPAD and adjusted the taxable income and resulting tax liability and credits accordingly. Unfortunately, for many taxpayers, the cost of follow-up correspondence with the IRS was likely to exceed the tax benefit from the deduction.

Taxpayers also received tax refunds stemming from the IRS's recalculation of taxable social security. The taxability of social security benefits depends upon modified AGI (MAGI).[35] The social security benefits worksheet in the Form 1040 instructions computes MAGI. According to those instructions, the DPAD entered on line 36 of Schedule 1 is **not** subtracted from income for purposes of determining MAGI.[36] However, when recalculating taxable social security, the IRS ignored those instructions and instead allowed the DPAD in determining MAGI.

33. PL 115-141.

34. Instructions for Form 8903.

35. IRS Pub. 915, *Social Security and Equivalent Railroad Retirement Benefits;* IRC §86.

36. Instructions for Form 1040.

The taxability of social security benefits is determined by IRC §86. Before 2018, the DPAD was **not** allowed in determining MAGI. Then, the TCJA removed §199 from the list of items that do not reduce income to arrive at MAGI.[37] Thus, after 2017, when starting with AGI, any DPAD amount is **not** added back. However, the Act reinstated the DPAD associated with a specified agricultural or horticultural cooperative for post-2017 years of the taxpayer, attributable to the QPAI of a cooperative with a taxable year beginning prior to 2018. This is the transition DPAD. Many farmers/patrons received notices from a cooperative in 2018 passing the transition DPAD amount to them.

The Act also reinstated §199 as an add-back to AGI for determining taxable social security benefits. If the taxpayer received a **notice from a cooperative regarding a transition DPAD,** MAGI was computed without the deduction. The result was increased taxable social security benefits. Therefore, taxpayers who collected social security benefits and also reported a transition DPAD should not have received refunds from the IRS if they calculated their MAGI without allowing the DPAD from the cooperative.

In addition, a calendar year 2018 Form 1040 may include a DPAD from a fiscal-year partnership or S corporation. According to the IRS, the 2018 calendar-year individual taxpayer is entitled to a DPAD passed through from these fiscal-year entities.[38] This amount, though, is not affected by the Act. Thus, taxpayers who reported a **DPAD from such a fiscal year pass-through entity** are allowed the deduction to arrive at MAGI in determining taxable social security benefits.[39]

Observation. The IRS computers failed to distinguish between the transition DPAD and the DPAD generated from fiscal year pass-through entities that are both reported on line 36 of the 2018 Schedule 1.

Impact on Taxpayers

Transition §199 DPAD amounts received from a **cooperative** do not reduce income to arrive at MAGI for the purpose of computing taxable social security benefits. The worksheets in the Form 1040 instructions are correct. IRS refunds are incorrect.

IRC §199 DPAD amounts received from **fiscal-year entities** reduce income to arrive at MAGI for purposes of computing taxable social security benefits. The worksheets in the Form 1040 instructions are incorrect. IRS refunds are correct if the tax preparation software determined MAGI by adding the §199 deduction to AGI.

Observation. The DPAD from a fiscal-year pass-through entity is a 1-year (2018) event. It does not exist for 2019. If Congress passes a retroactive technical corrections bill that addresses fiscal-year DPAD during 2019, it may become necessary to amend the 2018 Forms 1040 to remove the fiscal-year DPAD. Although the transition DPAD is temporary, it is possible for some transition DPAD to be reported on Form 1040 for 2019. In addition, when fiscal-year cooperatives allocate DPAD to fiscal-year partnerships or S corporations, this could result in individual taxpayers being entitled to transition DPAD on their 2020 Forms 1040.

After the transition years end, computations under §199A(g) continue to require the individual patron to reduce QBI by the lesser of 9% of QBI attributable to sales to the cooperative or 50% of W-2 wages attributable to those same sales.

37. TCJA §13305.

38. LB&I Directive 04-1118-016 (Nov. 21, 2018).

39. IRC §86(b)(2) after amendment by TCJA §13305.

PROPOSED DRAFT REGULATIONS

On June 19, 2019, the Treasury released proposed draft regulations for purposes of computing the §199A(g) deduction.[40] The proposed regulations clarify that QBI is defined as the net amount of qualified items of income, gain, deduction, and loss for any trade or business. A "qualified item of income" includes distributions for which the cooperative is allowed a deduction under IRC §§1382(b) and (c)(2), including patronage dividends and similar payments. For this purpose, the term "patronage dividends and similar payments" includes the following.[41]

- Money
- Property
- Qualified written notices of allocations
- Qualified per-unit retain certificates
- Money or property paid in redemption of a nonqualified written notice of allocation

Dividends on capital stock are not included in QBI.

Under Prop. Treas. Reg. §1.199A-7(c), patronage dividends or similar payments may be included in the patron's QBI to the extent that these payments meet the following conditions.

1. They are related to the patron's trade or business.
2. They are qualified items of income, gain, deduction, or loss at the cooperative's trade or business level.
3. They are not income from a specified service trade or business (SSTB) at the cooperative's trade or business level (except as permitted by the threshold rules of Treas. Reg. §1.199A-5(a)(2)).

However, such payments are only included in the patron's income if the cooperative provides the required information to the patron concerning the payments as provided in Prop. Treas. Reg. §§1.199A-7(c)(3) and (d)(3).[42]

The transition DPAD rules were reaffirmed in Prop. Treas. Reg. §1.199A-7(h)(2), thus validating the related complex calculations on 2018 tax returns.

The Patron's QBID

The amount of a patron's QBID that can be passed through by the cooperative is limited to the portion of the patron's deduction that is allowed with respect to QPAI to which the qualified payments (patronage dividends and per unit retains) made to the patron are attributable.[43] This means that the distribution from the cooperative must be of tax items that are allocable to the cooperative's trade or business on behalf of, or with, a patron. The cooperative calculates the patron's QBID amount in accordance with Treas. Reg. §1.199A-3(b). This is, essentially, the former DPAD computation except that nonpatronage income is not included in the computation.

The cooperative utilizes a 3-step process for computing the patron's QBID.

1. Separate patronage and nonpatronage gross receipts (and associated deductions).
2. Limit the patronage gross receipts to those that qualify as domestic production gross receipts.
3. Determine QPAI from the domestic, patronage-sourced gross receipts.[44]

40. REG-118425-18.
41. Prop. Treas. Reg. §1.199A-7(c)(1).
42. Prop. Treas. Reg. §1.199A-7(c)(2).
43. IRC §199A(g)(2)(E).
44. Prop. Treas. Reg. §1.199A-8(b).

A fourth step, computed at the patron level, involves the farmer-patron reducing the patron's QBID by a formula that is the **lesser of** 9% of QBI that relates to qualified payments from the cooperative, or 50% of the patron's W-2 wages paid that are allocable to the qualified payments from the cooperative.[45]

Observation. Because the formula uses the lesser of 9% of QBI or 50% of W-2 wages, a patron with no qualified W-2 wages is not subject to a reduction. It is important to keep in mind that under §199A(b)(4) and Prop. Treas. Reg. §1.199A-11(b)(1), wages paid in-kind to agricultural labor are not "qualified wages." However, wages paid to children under age 18 by their parents **are** qualified wages.

Note. In IRS Notice 2019-27, the IRS set forth various methods for calculating W-2 wages for purposes of computing the patron's QBID.[46]

IRC §199A(b)(7) requires the formula reduction described above even if the cooperative does not pass through any of the §199A(g) deduction to the patron for a particular tax year. If the patron has more than one business, QBI must be allocated among those businesses.[47]

Note. The proposed regulations do not mention how the formula reduction functions in the context of an aggregation election. For example, the formula reduction may need to be allocated to a portion of rental income if an election is made to aggregate rental income with income from the farming operation.

The formula reduction applies to the portion of a patron's QBI that relates to qualified payments from a cooperative. If the patron has negative QBI that is associated with business done with the cooperative, the 9% amount is always lower than the W-2 wage amount.

The proposed regulations provide guidance for allocating items to determine QBID in situations in which a farmer has sales to cooperatives and noncooperatives, as illustrated in the following example.

Example 1. Rich filed a joint tax return in 2019, reporting taxable income of $75,000 (without regard to §199A). He is a patron of a nonexempt specified cooperative and receives $20,000 in patronage dividends and $1,000 of allocated §199A(g) deductions from his cooperative.

In 2019, Rich's only trade or business is the following farming activity.

Gross receipts from sales to independent grain elevator	$150,000
Per-unit retain allocations from grain sales to the cooperative	80,000
Patronage dividends received from the cooperative	20,000
Total gross receipts	$250,000
Less: total expenses	(200,000)
Net income from farm trade or business	$ 50,000

The total expenses of $200,000 include $50,000 of W-2 wages paid by the business. Rich does not select the optional safe harbor (discussed next) and **instead uses another "reasonable method" specific to his facts and circumstances** that results in an allocation of $90,000 of these expenses (including $25,000 of W-2 wages) to qualified payments received from the cooperative.

45. IRC §§199A(b)(7)(A) and (B).

46. See also Prop. Treas. Reg. §1.199A-11.

47. Treas. Reg. §1.199A-3(b)(5).

As a self-employed farmer, Rich is subject to SE tax of $7,065 ($50,000 net income x 92.35% × 15.3%). This tax provides Rich with a deduction of $3,532 ($7,065 × 50%), which must be included in his QBID calculation and allocated between cooperative and noncooperative net income.

The computation of the §199A deduction for Rich follows.

Rich's cooperative and noncooperative gross receipts and associated deductions are separated as follows.

	Total	Cooperative Portion	Noncooperative Portion
Gross receipts	$250,000	$100,000	$150,000
Less: Expenses	200,000	90,000	110,000
Net income	$ 50,000	$ 10,000	$ 40,000
W-2 wages paid	50,000	25,000	25,000
One-half self-employment (SE) tax	3,532	706	2,826

The cooperative gross receipts are limited to $100,000, which is the amount of domestic production gross receipts.

Rich's QPAI is $10,000 ($100,000 domestic cooperative gross receipts – $90,000 allocable expenses).

The initial QBID for Rich's farm business is $9,294 (($50,000 net income – $3,532 one-half SE tax) × 20% QBI rate). The QBID must be reduced by the **lesser of:**

- **$836,** which is 9% of QBI related to qualified payments from the cooperative (($10,000 net income – $706 SE tax) × 9%), **or**
- **$12,500,** which is 50% of W-2 wages allocable to qualified payments from the cooperative ($25,000 × 50%)

The lesser of these two amounts is $836, which reduces the initial QBID of $9,294 to $8,458. Rich then adds the $1,000 §199A(g) deduction for a final QBID of **$9,458.**

This amount is less than Rich's overall taxable income limitation of $15,000 ($75,000 taxable income × 20%).

Note. This example was included in Prop. Treas. Reg. §1.199A-7(g). None of the examples in the regulation reduced QBID by the deduction for one-half of SE tax, but that is required.

Optional Safe Harbor. An optional safe harbor allocation method is available to determine the QBID reduction for patrons with taxable income under the applicable income threshold of §199A(e)(2) ($160,700 single, $321,400 MFJ, and $160,725 MFS for 2019).[48] Under the safe harbor, a patron must allocate the aggregate business expenses and W-2 wages ratably between income from qualified payments and income from other gross receipts to determine QBI.[49] Thus, the amount of deductions apportioned to determine QBI allocable to qualified payments must be equal to the proportion that total qualified payments bears to total gross receipts used to determine QBI. The same proportion applies to determine the amount of W-2 wages allocable to the portion of the trade or business that received qualified payments.

> **Note.** The proposed regulations, in attempting to illustrate the calculation, only mention gross receipts from grain sales. There is no mention of gross receipts from sales of farm equipment, for example. Based on the language of Prop. Treas. Reg. §1.199A-7(f)(2)(ii), gross receipts from the sale of equipment and machinery should be included in the calculation and the farmer must allocate gross receipts from equipment sales between patronage and nonpatronage income. In prior years, depreciation may have been allocated between patronage and nonpatronage income. The example also does not address how government payments, custom work, crop insurance proceeds, or other gross receipts are allocated.

This means the patron must pay special attention to box 7 of Form 1099-PATR, *Taxable Distributions Received From Cooperatives,* (shown below). Box 7 contains the amount of the qualified payments from the cooperative allocable to the patron that were used in computing the deduction for the patron at the cooperative level and then passed through to the patron.

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		1 Patronage dividends $ 2 Nonpatronage distributions $ 3 Per-unit retain allocations $	OMB No. 1545-0118 2019 Form 1099-PATR	Taxable Distributions Received From Cooperatives
PAYER'S TIN	RECIPIENT'S TIN	4 Federal income tax withheld $		Copy B For Recipient
RECIPIENT'S name		5 Redemption of nonqualified notices and retain allocations $	6 Domestic production activities deduction $	This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address (including apt. no.)		7 Qualified payments $	8 Investment credit $	
City or town, state or province, country, and ZIP or foreign postal code		9 Work opportunity credit $	10 Patron's AMT adjustment $	
Account number (see instructions)		11 Other credits and deductions $		

Form **1099-PATR** (keep for your records) www.irs.gov/Form1099PATR Department of the Treasury - Internal Revenue Service

48. Rev. Proc. 2018-57, 2018-49 IRB 827.

49. Prop. Treas. Reg. §1.199A-7(f)(2)(ii).

Example 2. Use the same facts as **Example 1,** except that Rich uses the optional safe harbor allocation method. Expenses and W-2 wages paid are allocated based on gross receipts from qualified payments and gross receipts from other payments.

The computation of the §199A deduction for Rich using the optional safe harbor follows.

	Total	Cooperative Portion	Noncooperative Portion
Gross receipts	$250,000	$100,000	$150,000
Expenses	200,000	80,000	120,000
Net income	50,000	20,000	30,000
W-2 wages paid	50,000	20,000	30,000
One-half SE tax	3,532	1,413	2,119

Net income from the cooperative portion is 40% ($20,000 ÷ $50,000), and the one-half SE tax deduction allocated to the cooperative portion is $1,413 ($3,532 × 40%).

The initial QBID for Rich's farm business is $9,294 (($50,000 net income – $3,532 one-half SE tax) × 20% QBI rate). This amount must be reduced by the **lesser of:**

- **$1,673,** which is 9% of QBI related to qualified payments from the cooperative (($20,000 net income – $1,413 SE tax) × 9%), **or**
- **$10,000,** which is 50% of W-2 wages allocated to qualified payments from the cooperative ($20,000 × 50%)

The lesser of these two amounts is $1,673, which reduces the initial QBID of $9,294 to $7,621. Rich then adds the $1,000 §199A(g) deduction for a final QBID of **$8,621.**

This amount is less than the overall taxable income limitation of $15,000 ($75,000 taxable income × 20%).

A patron with taxable income above the income threshold[50] (shown earlier) who receives patronage dividends (or similar payments) from a cooperative and who is conducting a trade or business may be subject to the W-2 wages and unadjusted basis immediately after acquisition (UBIA) limitation (qualified property limit). If the limit applies, the patron calculates their W-2 wage and UBIA limitations without regard to the cooperative's W-2 or UBIA amounts.[51] This means the cooperative (unlike a relevant pass-through entity) does not allocate its W-2 wages or UBIA to patrons.[52] Instead, a patron allocates (by election) W-2 wages and UBIA between patronage and nonpatronage income using any reasonable method (based on all the facts and circumstances) that clearly reflects the income and expense of each trade or business.[53]

Note. For information about the W-2 wages and UBIA limits, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: QBID Update.

Observation. An allocation method might be based, for example, on the number of bushels of grain the patron sells during the year to cooperatives and noncooperatives. Once an election is made with respect to an allocation approach, it applies to all subsequent years.

50. IRC §199A(g)(2)(B).

51. Prop. Treas. Reg. §1.199A-7(e)(2).

52. Ibid.

53. Prop. Treas. Reg. §1.199A-7(f)(2)(i).

The patron's QBID passed through from the cooperative (which is not limited by W-2 wages at the patron level) is limited to the patron's taxable income taking into account the nonpatron QBID. The nonpatron QBID is limited to 20% of taxable income, not including net capital gains. Any unused patron QBID is lost. No carryover or carryback provision applies because the taxable income limitation calculation[54] never results in a potential carryover or carryback.

Identification by the Cooperative. A cooperative must identify the amount of a patron's QBID that it is passing through to a patron in a notice that is mailed to the patron with Form 1099-PATR during the **applicable payment period,** which is no later than the 15th day of the ninth month following the close of the cooperative's tax year.[55]

A patron uses the information the cooperative reports to determine the patron's QBID. If the cooperative does not report the information on or before the Form 1099-PATR due date, no distributions from the cooperative count towards the patron's QBI. The effective date for this provision is June 19, 2019.[56]

> **Note.** The preamble to the proposed regulations states that the identification rules apply to both exempt and nonexempt cooperatives as well as patronage and nonpatronage distributions.

Is the Patron's Business an SSTB? The proposed regulations indicate that a patron must determine whether the trades or businesses it directly conducts are SSTBs.[57] This is because the cooperative must report to the patron the amount of tax items from an SSTB that the cooperative directly conducts (based on the application of the gross receipts de minimis rule of Treas. Reg. §1.199A-5(c)(1)) that is used to determine if a trade or business is an SSTB.

The patron then determines if the distribution from the cooperative can be included in the patron's QBI (based on the patron's taxable income and the phase-in range and threshold that applies to an SSTB). The cooperative must report to the patron the amount of SSTB income, gain, deduction, and loss that are qualified items with respect to any SSTB directly conducted by the cooperative. This is reported on an attachment to or on the Form 1099-PATR (or any successor form) that the cooperative issues to the patron, unless otherwise provided by the instructions to the form.

DEDUCTING COSTS ASSOCIATED WITH ITEMS PURCHASED FOR RESALE

In general, a farmer or rancher using the cash method of accounting deducts business-related expenses in the year they are paid. However, in certain situations (such as livestock purchased for resale or growing crops associated with the purchase of a farm), special circumstances may emerge that are affected by the TCJA provisions.

> **Note.** For more information on the cash method of accounting, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Small Business Issues.

The cash method of accounting allows the taxpayer to claim a deduction in the year the expense is paid. However, there are some special situations in agriculture when the deduction is deferred. The pre-TCJA rules can still be followed. However, if a current deduction is desired, there may be ways to accomplish this result.

---

54. IRC §199A(a)(2).

55. IRC §§199A(g)(2)(A) and 1382(d); Prop. Treas. Reg. §1.199A-8(d)(3).

56. Prop. Treas. Reg. §§1.199A-7(c)(3) and (d)(3).

57. Prop. Treas. Reg. §1.199A-7(d)(2).

LIVESTOCK

For farmers and ranchers utilizing the cash method of accounting, deductions can be taken for the cost of livestock and other items purchased for resale **only when** the items are sold.[58]

Example 3. Bob, a cattle feeder, bought calves and yearlings. He held them for approximately nine to 18 months and then sold them as beef cattle in a later year. Bob was on the cash method of accounting and deducted the cost of the cattle in the year of purchase as an operating expense rather than deferring the deduction until the year he sold the cattle. The IRS disallowed the deduction for the cost of the cattle in the year of purchase because Bob's gain in the later year of sale should be reduced by the cost of the purchase.

Note. The facts of this example are similar to those of *Alexander v. Comm'r.* The Tax Court upheld the IRS's position and the underlying Treasury regulation.[59]

OTHER AGRICULTURAL PRODUCTS

The rule applied in the *Alexander* case is widely recognized as the "feeder calf" rule, whereby the cost of feeder calves is not deductible until the calves are sold. However, the rule has much broader application beyond the feeder calf scenario. For example, in *Dodds v. Comm'r,*[60] the Tax Court held that the rule required the taxpayers to deduct the cost of their Valencia orange tree grove attributable to the growing orange crop only when the crop was sold. The Tax Court noted that Treas. Reg. §1.61-4 applies to livestock **and** produce.

The same tax treatment applies to grain and other items purchased for resale. For example, the purchased grain acquires an income tax basis equal to the basis purchase price if the following conditions are met.

1. A farmer pledges grain to the Commodity Credit Corporation (CCC) as collateral for a loan.
2. The grain goes out of condition.
3. The grain is sold.
4. The grain is replaced with the same quantity of grain (meeting CCC standards for quality) that is sold.

The purchase price amount then offsets (either partially or fully) the amount realized on the later sale of the grain.

The same rationale applies when a farmer buys a commodity certificate and then uses the certificate to acquire grain for later resale. The purchase price of the grain establishes the farmer's tax basis in the grain. That tax basis then offsets the gain (or creates a loss) when the grain is sold.

INVENTORY METHOD APPLICATION

The IRS also takes the position that a last-in, first-out (LIFO) method may not be used to determine inventory costs that can be deducted in the year of sale. In Rev. Rul. 88-60,[61] the taxpayer was engaged in the business of acquiring livestock for the purpose of resale. The taxpayer, a corporation, utilized the cash method and computed the profits from the sale of the livestock by determining the cost of the livestock sold as if the latest cattle acquired was the first sold. The cost basis of the remaining unsold cattle at the end of the year reflected the cost of the earliest cattle the taxpayer had acquired.

---

58. Treas. Reg. §1.61-4(a).
59. *Alexander v. Comm'r,* 22 TC 234 (1954), *acq.* 1954-2 CB 3.
60. *Dodds v. Comm'r*, TC Memo 1986-174 (Apr. 24, 1986).
61. Rev. Rul. 88-60, 1988-2 CB 30.

The IRS took the position that this method did not reflect the actual cost of the livestock sold and that it was not permitted by Treas. Reg. §1.61-4 because it reflected the cost of the latest purchases of calves and yearlings. The IRS determined that this was not consistent with the cash method of accounting. Instead, the cost should be subtracted from the particular item sold and could not be deducted from other similar items sold. Allowing the use of the LIFO method would allow the taxpayer to deduct part of the cost of the feeder cattle in the year of purchase rather than deferring the deduction until the year of sale. In Treas. Reg. §1.61-4, **cost** was defined as the actual cost of the livestock rather than the base year cost as determined under LIFO.[62]

FARMLAND WITH GROWING CROP

When a farm is purchased that has a growing crop (or crops) on it, the IRS position is that the portion of the purchase price allocated to the growing crop does not produce a current income tax deduction. Instead, the amount allocated to the growing crop is capitalized and taken into account when determining net profit or loss in the year that the crop is sold.[63] It is not deductible as a purchase of "feed" unless the taxpayer intends to feed the crop to livestock. In that case, a current deduction seems to be permissible for a reasonable amount of the acquired crop that is necessary to feed the taxpayer's livestock.[64]

POULTRY

A farmer who uses the cash method of accounting can take a current deduction for the cost of purchasing baby chick and egg-laying hens. To take a current deduction, the cash method must be consistently followed and clearly reflect income. The same is true if the chicks and hens are purchased for the purpose of raising and reselling at a later time. In Rev. Rul. 60-191,[65] the IRS took this position because it determined the cost of the chicks was nominal compared to the cost of raising them and because cost identification would be difficult.[66] Whether that same rationale applies to other types of poultry (e.g., ostriches and emus) is an open question.

IMPACT OF THE TCJA

Section 13102 of the TCJA adds several amendments to the accounting rules for "small" businesses. In a significant change from prior law, for tax years beginning after 2017, a farming business (including a farm C corporation or a farming partnership with a C corporation partner) can qualify for the cash method of accounting if average annual gross receipts over the prior three years do not exceed $25 million ($26 million for 2019).[67]

The TCJA also contains a provision that exempts taxpayers who meet the gross receipts test from the requirement to account for inventories so as to clearly reflect income. However, the taxpayer's method of accounting for inventory must either treat the inventory as nonincidental materials and supplies or conform to the taxpayer's method of accounting reflected in an applicable financial statement (AFS) for the tax year. If the taxpayer does not have an AFS and does not choose to treat inventory as nonincidental materials and supplies, the taxpayer's method of accounting must conform to the taxpayer's books and records "prepared in accordance with the taxpayer's accounting procedures."[68] Incidental supplies are those that are minor or secondary items, for which no record of consumption is kept and no beginning or ending inventory is maintained. Supplies that do not meet these tests are nonincidental supplies.[69]

Observation. It is not presently known how the IRS will view the TCJA changes on this issue.

62. See also Ltr. Rul. 8406003 (Oct. 18, 1983); *Peterson v. Vinal,* 225 F.Supp. 478 (D. Neb. 1964).

63. Rev. Rul. 85-82, 1985-1 CB 57. See also Ltr. Rul. 8350002 (Aug. 8, 1983); GCM 39096 (Dec. 21, 1983).

64. Ibid.

65. Rev. Rul. 60-191, 1960-1 CB 78.

66. See also Ltr. Rul. 8528027 (Apr. 15, 1985).

67. IRC §§448(c)(1)(A)(i) and (ii).

68. IRC §471(c).

69. Treas. Reg. §1.162-3.

If a farmer accounts for inventory as nonincidental materials and supplies, inventory accounting methods do not apply. As noted earlier, the IRS does not allow the use of LIFO, but first-in, first-out (FIFO) or average cost methods can be used.[70]

> **Note.** If the farmer's books and records consistently expense purchases of livestock and other items that are sold in later years and the farmer does not have an AFS, a current deduction may be available.

Support for this treatment can be found in the tangible property regulations. The IRS provided a de minimis safe harbor limit for those without an AFS.[71] In IRS Notice 2015-82,[72] the IRS set the safe harbor at $2,500 (effective beginning with the 2016 tax year) for purposes of administrative convenience. This safe harbor allows a taxpayer to deduct amounts that do not exceed the safe harbor limit that are expended for the acquisition or production of new property or for the improvement of existing property that would otherwise have to be capitalized under IRC §263(a). To use the safe harbor, the item must be substantiated by an invoice. The safe harbor applies on a per-item basis if stated that way on the invoice.

> **Observation.** The AFS has a different definition under §471(c) than for purposes of the de minimis safe harbor. Under §471(c), an AFS is an audited financial statement in conformance with generally accepted accounting principles (GAAP) (as defined in §451(b)(3)). However, for the purposes of the safe harbor, the AFS is the applicable financial statement with the highest priority pursuant to Treas. Reg. §1.263(a)-1(f)(4). The AFS priority ranking from highest to lowest is as follows.
>
> 1. An AFS required to be filed with the Securities and Exchange Commission (SEC)
> 2. An AFS audited by a CPA
> 3. An AFS required to be provided to the federal or a state government or any federal or state agency (other than the SEC or the IRS)

For a farmer eligible for the cash method of accounting, the prior law current write-off rule for baby chicks and hens still applies. In addition, a current deduction is allowed (under the tangible property regulations) for the cost of tangible property that has an acquisition cost (or production cost) of $200 (per unit or per item) or less. That $200 amount should cover the cost, for example, of individual feeder pigs. The acquisition cost of other livestock purchased for resale, such as cattle, is also currently deductible if the acquisition cost is within the $2,500 safe harbor.

If the taxpayer has not previously taken a current deduction for the cost of livestock purchased for resale, changing to this method is considered a change in accounting method that requires the taxpayer to file Form 3115, *Application for Change in Accounting Method,* and make an IRC §481(a) adjustment.[73]

> **Note.** For more information about filing Form 3115 and §481(a) adjustments, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Small Business Issues.

> **Note.** To treat inventory as nonincidental materials and supplies, the designated change number used on Form 3115 is 235. There is no guarantee the IRS will grant audit protection for the change. Additionally, even though the IRS grants consent for the change in the method of accounting for livestock purchased for resale, this does not mean the method is permissible and creates no presumption the change is a permissible method of accounting under a provision of the Code.[74]

70. See Rev. Proc. 2002-28, 2002-1 CB 815.
71. See Treas. Reg. §1.263(a)-1(f)(1)(ii)(D).
72. IRS Notice 2015-82, 2015-50 IRB 859.
73. IRC §471(c)(4).
74. See Rev. Proc. 2018-40, 2018-34 IRB 320.

SALE OR EXCHANGE OF A PARTNERSHIP INTEREST

Partnerships are a common entity form for farming operations. This is particularly true when the farming operation participates in federal farm programs. A general partnership is the entity form for a farming operation that can result in the maximization of federal farm program payments. However, when a partner sells or exchanges a partnership interest, the associated tax issues can be complex.

GENERAL RULE

When a partner sells or exchanges a partnership interest to anyone other than the partnership itself, the partner generally recognizes a capital gain or loss on the sale.[75] This may result in a positive tax result when a gain is involved because of the favorable tax rates that apply to long-term capital gain income. However, when there is a loss, the tax result may not be advantageous because of the limited ability to deduct capital losses (e.g., capital losses offset capital gain plus $3,000 of other income for the year).

When a partner sells their partnership interest back to the partnership in liquidation of the partner's interest and takes a property distribution, the liquidating partner generally does not recognize gain (except to the extent money is received that exceeds the partner's basis in the partnership interest or the partner is relieved of indebtedness). The liquidating partner receives a basis in the distributed property equal to what the partner's basis was in the partnership interest.[76]

6

EXCEPTION

The general rule that a partner's sale or exchange of their partnership interest triggers capital gain does not apply to the extent the gain realized on the transaction is attributable to "hot assets."

"Hot assets" (as defined under IRC §751) include the following.

- Unrealized receivables
- Inventory items of the partnership

In essence, "hot assets" are assets that have not already been recognized as income, but eventually will be recognized by the partnership as ordinary income. The income will be allocated to the partner in the ordinary course of partnership business and taxed at ordinary income tax rates.

The partner's sale or exchange of their interest merely accelerates the recognition of the income (such as with depreciation recapture). Thus, the income on the transaction is recharacterized from capital to ordinary.[77] The rationale for the recharacterization is that, if the partnership were to sell such hot assets, ordinary income or loss would be recognized on the sale. Thus, when a partner sells or exchanges a partnership interest, the partner should recognize ordinary income on the portion of the income from the sale of the partnership interest that is attributable to the hot assets.

> **Observation.** If this recharacterization rule did not apply, a partner would be able to transform what would have been ordinary income into capital gain by selling or exchanging their partnership interest.

Similarly, when a partnership distributes property to a partner in exchange for the partner's interest in the hot assets of the partnership, the transaction may be treated as a sale or exchange of the hot assets between the partner and the partnership, generating ordinary income.

A partner involved in farming can recognize ordinary income **and** a capital loss, even though the partner had an overall gain on the sale. The ordinary income is taxed immediately, but the capital loss is limited as described above.

75. IRC §741.

76. Treas. Reg. §1.731-1.

77. IRC §751(a).

Types of "Hot Assets"

Unrealized Receivables. According to IRC §751(c) and Treas. Reg. §§1.751-1(c)(4)(iii) and (v), there are **three** categories of unrealized receivables.

1. Goods
2. Services
3. Recapture items

In the farming context, the "goods" terminology contained in the definition of "unrealized receivables" includes property used in the trade or business of farming subject to depreciation or amortization as defined by IRC §1245. This can include the following.

- Personal property (§1245(a)(3)(A)) such as farm equipment and machinery
- Horses, cattle, hogs, sheep, goats, and mink and other furbearing animals, irrespective of their use or the purpose for which they are held[78]
- Certain real property for which accelerated depreciation deductions have been taken[79]
- Assets such as farm fences and farm field drainage tile
- Grain bins and silos (e.g., a facility used for the bulk storage of fungible commodities)[80]
- Single-purpose agricultural or horticultural structures as defined in IRC §168(i)(13)[81]

The ordinary income treatment may also include real property under IRC §1250 that has been depreciated using accelerated methods in excess of straight-line depreciation. Examples of farm property included in the category of §1250 property are barns, storage sheds, and work sheds. If these properties are sold after the end of their recovery period, there is no ordinary income. Farmland on which soil and water conservation expenses have been recaptured may also be included under this provision.[82]

The "unrealized receivables" definition also includes rights (contractual or otherwise) to payment for goods delivered (or to be delivered) to the extent the payment would be treated as received for property other than a capital asset or services rendered (or to be rendered). The income from such rights to payment is considered unrealized receivables if the payment was not previously included in income under the partnership's method of accounting. The rights must have arisen under contracts or agreements in existence at the time of the sale or distribution, although the partnership may not be able to enforce payment until a later time.[83]

Observation. In the agricultural realm, the definition of unrealized receivables includes the present value of ordinary income attributable to deferred payment contracts for grain and livestock, installment notes for assets sold under the installment method, cash rent lease income, and agricultural commodity production contracts.

78. Treas. Reg. §1.1245-3(a)(4).
79. IRC §1245(a)(3)(C).
80. IRC §1245(a)(3)(B)(iii).
81. IRC §1245(a)(3)(D).
82. IRC §§751(c) and 1252(a).
83. Treas. Reg. §1.751-1(c)(1).

Inventory. The other category of "hot assets" includes stock in trade or other property of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the tax year and is property the taxpayer holds primarily for sale to customers in the ordinary course of business.[84] Whether a taxpayer holds property as a capital asset or for use in the ordinary course of business depends on the facts.[85]

For many farm partnerships, inventory items constituting hot assets may include harvested crops, livestock that are being fed out, poultry, tools and supplies, repair parts, as well as crop inputs (e.g., seed, feed, and fertilizer) not yet applied to the land. An unharvested crop is not included in inventory if the unharvested crop is on land the taxpayer uses in the trade or business and held for more than a year, if the land and the crop are sold or exchanged (or involuntarily converted) at the same time and to the same person.[86] Inventory also includes any other property that, if sold by the partnership, would **not** be considered a capital asset or §1231 property.[87]

IRC §1231 property is defined as real or depreciable business property held for over a year (two years for some livestock). Thus, for a farm partnership, the following items are included in the definition of "inventory" because they are not §1231 property.

- Single-purpose agricultural or horticultural structures, grain bins, or farm buildings held for one year or less from the date of acquisition[88]
- Personal property (other than livestock) held for one year or less from the date of acquisition[89]
- Cows and horses held for less than 24 months from the date of acquisition[90]
- Other livestock (regardless of age, but not including poultry) held by the taxpayer for less than 12 months from the date of acquisition[91]

QUALIFIED BUSINESS INCOME DEDUCTION[92]

As mentioned earlier, the TCJA[93] created the §199A QBID effective for tax years beginning after 2017 and before 2026. The provision creates up to a 20% deduction from taxable income for QBI generated from an activity other than a C corporation. Only ordinary income can be QBI; income taxed as capital gain does not qualify. If gain on the sale or exchange of a partnership interest involves hot assets, it is therefore possible that it could be QBI because the gain is taxed as ordinary income.

Under Prop. Treas. Reg. §1.199A-3, any gain attributable to a partnership's hot assets is considered attributed to the partnership's trade or business and may constitute QBI in the hands of the partner. Thus, if IRC §§751(a) or (b) applies on the sale or exchange of a partnership interest, the gain or loss attributable to the partnership assets that gave rise to ordinary income is QBI. Given the potentially high amount of hot assets that a farm partnership might contain (particularly when depreciation recapture is considered), the QBID can play an important role in minimizing the taxes from a sale or exchange of a partnership interest.

84. IRC §751(d) referencing IRC §1221(a)(1).
85. See, e.g. *U.S. v. Winthrop,* 417 F.2d 905 (9th Cir. 1969).
86. IRC §1231(b)(4).
87. IRC §751(d)(2).
88. IRC §1231(b)(1).
89. Ibid.
90. IRC §1231(b)(3)(A).
91. IRC §1231(b)(3)(B).
92. IRC §199A.
93. PL 115-97.

THE IMPACT OF THE IRC §754 ELECTION

When a partnership interest is sold, not only is the proper characterization of the gain (or loss) important, but the timing of the gain (or loss) is critical. The timing issue is related to whether the partnership has an IRC §754 election in place for the year that the interest is sold (or upon liquidation of the partnership). This election generates tax "adjustments" for the purchaser of a partnership interest by bringing together the concepts of "inside" and "outside" basis.

> **Observation.** For many farm entities taxed as partnerships, this election is also important upon the death of a partner. The following discussion about changes in basis and the timing of deductions may apply to partners inheriting a partnership interest.

Partnership Inside Basis

Partnership "inside basis" refers to the adjusted basis a partnership holds in each of its assets and how that asset basis is reflected in the partners' capital accounts. Typically, inside basis is derived from partner contributions and from purchases the partnership makes with partnership funds. Inside basis determines each partner's tax basis according to the individual assets contributed to the operation of the partnership.

Example 4. During 2008, Alicia, Barry, Charles, and Deidre formed Happy Valley Farm Partnership. They each contributed $500,000 to the partnership. With the $2 million of contributed cash, the partnership bought land for $1.2 million and other nondepreciable[94] assets for $800,000. As a result, after formation and purchase of assets, the partnership's balance sheet is as follows.

	Basis
Land	$1,200,000
Other nondepreciable assets	800,000
Total assets	$2,000,000
Capital account: Alicia	$ 500,000
Capital account: Barry	500,000
Capital account: Charles	500,000
Capital account: Deidre	500,000
Total equity	$2,000,000

Each partner has a capital account equal to the amount of cash that particular partner contributed to the partnership. The total of the partners' capital accounts equals the total basis the partnership has in its assets. Thus, the partnership has an inside basis in its partnership assets of $2 million, and each partner's share of that inside basis is $500,000.

Partner's Outside Basis

"Outside basis" is the basis each partner holds in the partner's partnership interest. Upon contribution of property to a partnership, the partner takes an initial basis in the partnership interest equal to the amount of cash and the adjusted tax basis of any property contributed to the partnership.[95] In **Example 4,** each of the partners takes an initial "outside basis" in the partnership equal to the cash contribution of that partner — $500,000. Likewise, each partner's outside basis equals their share of the basis of the partnership's assets (the inside basis) of $500,000.

94. Examples of nondepreciable assets are discussed later in this chapter.

95. IRC §721(a).

Example 5. Use the same facts as **Example 4.** In early 2018, the value of the land held by the partnership was appraised at $1.8 million and the other assets were valued at $800,000. Assuming there were no other changes, the partnership's balance sheet in 2018 is as follows.

	Basis	Fair Market Value (FMV)
Land	$1,200,000	$1,800,000
Other nondepreciable assets	800,000	800,000
Total assets	$2,000,000	$2,600,000
Capital account: Alicia	$ 500,000	$ 650,000
Capital account: Barry	500,000	650,000
Capital account: Charles	500,000	650,000
Capital account: Deidre	500,000	650,000
Total equity	$2,000,000	$2,600,000

Observation. While the **value** of the partnership's assets has increased, the basis of the assets remains at $2 million. Likewise, each partner's outside basis in the partnership remains unchanged at $500,000 per partner. Nothing else has happened (e.g., income, distributions, debt assumption, etc.) that would cause basis adjustments.

In mid-2018, Alicia sells her interest to Edwin for $650,000. Alicia recognizes gain of $150,000 on the sale[96] ($650,000 – $500,000 basis). Edwin's basis in the partnership interest (outside basis) is the purchase price of $650,000.[97] However, Edwin's share of the inside basis the partnership holds in its assets is $500,000. With respect to inside basis, Edwin merely "steps into the shoes" of Alicia's previous capital account of $500,000. Thus, after the transaction, Edwin's capital account differs from his tax basis, as shown in the following table.

	Capital Account Inside Basis	Tax Basis Outside Basis
Barry	$ 500,000	$ 500,000
Charles	500,000	500,000
Deidre	500,000	500,000
Edwin	500,000	650,000
Total equity	$2,000,000	$2,150,000

The capital account values represent "inside basis," which is the partnership's basis of assets owned. The tax basis values represent "outside basis," which is the partner's basis in their partnership interest.

96. IRC §741.

97. IRC §1012.

Example 6. Use the same facts as **Example 5.** After Edwin buys Alicia's interest, the partnership sells the land in 2018 for $1.8 million. The sale triggers gain at the partnership level of $600,000 ($1.8 million – $1.2 million basis).[98] Because each partner owns 25% of the partnership, they are each allocated $150,000 of the gain. The $150,000 gain increases each partner's capital account and tax basis.[99]

Immediately after the sale, the balance sheet is as follows.

	Capital Account	FMV
Cash	$1,800,000	$1,800,000
Other nondepreciable assets	800,000	800,000
Total assets	$2,600,000	$2,600,000
Capital account: Barry	$ 650,000	$ 650,000
Capital account: Charles	650,000	650,000
Capital account: Deidre	650,000	650,000
Capital account: Edwin	650,000	650,000
Total equity	$2,600,000	$2,600,000

Because the allocation of gain increases each partner's capital account and tax basis, the $150,000 disparity between Edwin's capital account of $650,000 and his outside basis of $800,000 remains.

	Capital Account Inside Basis	Tax Basis Outside Basis
Barry	$ 650,000	$ 650,000
Charles	650,000	650,000
Deidre	650,000	650,000
Edwin	650,000	800,000
Total equity	$2,600,000	$2,750,000

Observation. When Alicia sold her 25% interest to Edwin, she recognized $150,000 of gain. This was likely related to the $600,000 of underlying appreciation in the land. The $650,000 Edwin paid Alicia for her partnership interest only gave him outside basis and had no effect on the basis of the property inside the partnership. When the land was subsequently sold by the partnership, the entire $600,000 of appreciation was recognized as gain, and $150,000 of that gain was allocated to Edwin. Thus, both Alicia and Edwin paid tax on the same gain.

98. IRC §1001.

99. IRC §704.

Example 7. Use the same facts as **Example 6.** In 2020, the partnership sells its remaining assets for $800,000 and liquidates by distributing its cash of $2.6 million. In accordance with IRC §704, the partnership makes a liquidating distribution to each partner in an amount tied to each partner's positive balance in their capital account. Because each partner's capital account (inside basis) is $650,000, each partner receives $650,000 of cash upon liquidation. In addition, upon the partnership's liquidation, each partner recognizes gain or loss equal to the difference between the amount received and the partner's basis in the partnership interest.[100]

Observation. Each partner's basis in their partnership interest is the partner's **outside basis**. For Barry, Charles, and Deidre, these two amounts are the same ($650,000). However, Edwin has a $150,000 difference ($650,000 inside basis vs. $800,000 outside basis).

Upon liquidation, gain or loss is recognized as follows.

	Capital Account Cash Distributed	Tax Basis Outside Basis	Gain or Loss
Barry	$ 650,000	$ 650,000	$ 0
Charles	650,000	650,000	0
Deidre	650,000	650,000	0
Edwin	650,000	800,000	(150,000)
Total	$2,600,000	$2,750,000	($150,000)

While neither Barry, Charles, nor Deidre recognize gain on the liquidation, Edwin receives $650,000 of cash upon liquidation for his interest that has an outside tax basis of $800,000. The result is a $150,000 loss to Edwin on liquidation of the partnership. This **capital loss** is triggered in a different tax year than the $150,000 gain Edwin recognized from the partnership's sale of the land. Alicia previously recognized this portion of the gain upon sale of her partnership interest to Edwin. Because Edwin's loss does not offset his gain in the earlier year, if Edwin does not have any capital gain in the year the partnership liquidates, he can claim only $3,000 of the $150,000 capital loss in the current tax year.[101]

Note. From inception of the partnership to liquidation, Barry, Charles, Deidre, and Edwin recognized a total gain of $600,000 on the sale of the land. Alicia recognized gain of $150,000 on the sale of her partnership interest. Edwin recognized a loss of $150,000 on liquidation of the partnership. The total gain recognized nets out to $600,000, the amount of the gain on the sale of the land. However, the gain to Alicia does not match the loss to Edwin due to timing of the sales — they are recognized in different tax years. This inequitable tax result could have been remedied if the partnership made a §754 election either for the year Alicia sold her interest to Edwin or when partnership property was distributed.[102]

6

100. See IRC §731.

101. IRC §1212.

102. IRC §743 is the governing Code section when a §754 election is made upon the sale of a partnership interest. When the election is made upon the distribution of partnership property, the governing Code section is IRC §734.

While the §754 election is merely the statement that basis is changing, the following sections govern the computation of the basis amount to be changed.

- §734: Distribution of partnership property
- §743: Transfer of partnership interest
- §755: Rules for allocation of basis among types of property

Effect of Election on Basis

Under IRC §743, the inside basis of partnership property is adjusted as the result of a transfer of a partnership interest if a §754 election is in effect. With the election, the partnership is permitted to increase the adjusted **inside** basis of its property by the excess of the purchasing partner's **outside** basis in the partnership interest over the purchasing partner's share of the partnership's inside basis of the partnership assets. **The increase is specific to the purchasing partner.**

Example 8. Use the same facts as **Example 5,** except the partnership made a §754 election for the year in which Edwin purchased Alicia's interest. Accordingly, the partnership increased the basis of its land by the amount that Edwin's outside basis in the acquired interest ($650,000) exceeded his share of the inside basis ($500,000). Thus, the partnership increased the basis of its land by $150,000, which is the same amount as the gain that Alicia recognized on the sale.

Observation. The basis increase resulting from a §754 election is a tax concept only. Unless the partnership files a tax basis balance sheet, the election does not affect the balance sheet. Instead, the additional basis in the land is reflected outside the balance sheet, such as on the tax depreciation schedule. In addition, the basis increase is only specific to the purchasing partner.

Example 9. Use the same facts as **Example 6** and **Example 8.** When Happy Valley Farm Partnership sold its land for $1.8 million, it recognized **book gain** of $600,000, because its basis in the land remained $1.2 million for book purposes. Thus, for book purposes, the gain was allocated $150,000 each to Barry, Charles, Deidre, and Edwin, and increased each of their capital accounts from $500,000 to $650,000. However, because the partnership made a §754 election, the partnership's inside basis in the land for tax purposes was $1.35 million (rather than $1.2 million) in accordance with §743. The partnership recognized $450,000 of taxable gain with the §754 election in place (rather than $600,000). However, the $450,000 was not allocated equally among the partners because the $150,000 increase in land basis was specific to Edwin. As a result, the $450,000 of gain was allocated $150,000 to Barry, $150,000 to Charles, and $150,000 to Deidre. No gain was allocated to Edwin. This gain increased the outside basis of Barry, Charles, and Deidre.

With the §754 election in place, each partners' respective inside basis (capital account) and their outside basis is $650,000.

Example 10. Use the same facts as **Example 7,** except the §743 adjustment was made. The basis for each partner is as follows:

	Capital Account Inside Basis	Tax Basis Outside Basis	Gain or Loss
Barry	$ 650,000	$ 650,000	$0
Charles	650,000	650,000	0
Deidre	650,000	650,000	0
Edwin	650,000	650,000	0
Total equity	$2,600,000	$2,600,000	$0

Observation. With a §754 election in place, no further gain or loss is allocated to any partner. Without the election, Edwin recognized $150,000 of tax gain when the land was sold and a corresponding $150,000 capital loss upon liquidation. That created a timing problem for Edwin. The §754 election eliminates the timing problem. Edwin does not recognize gain when the land is sold or when the partnership is liquidated. The appreciation in land value occurred while Alicia was a partner and she recognized that appreciation as taxable gain at the time she sold her interest to Edwin.[103]

Note. If the partnership owned depreciable property rather than land, a §754 election would increase the basis of the depreciable assets. The increase is specific to Edwin. The partnership would then depreciate the increase of the inside basis based on the useful life of the underlying property. Any depreciation deduction the basis increase generates would be specifically allocated to Edwin.

Observation. An S corporation is at a disadvantage compared to a partnership with respect to liquidation and the §754 basis election. When a **partner** dies or there is a sale of a partnership interest, the new basis for the partner's interest can be applied to the partnership assets and new deductions can begin for the acquiring partner if an election is made. When a **shareholder** dies or there is a sale of stock, the basis of S corporation stock changes but there is no impact on the inside basis of the corporate assets. However, there is nothing in the Code for an S corporation comparable to the §751 "hot asset" rules.

Contribution of Property With a Built-In Loss

If a partner contributes property with an FMV less than the property's adjusted basis (i.e., the property has a built-in loss), that amount is allocated solely to the contributing partner and the deemed basis of that asset to any other partner is the FMV when the asset is contributed to the partnership.[104] Without a §754 election, later changes in the value of the asset may cause a distortion in the tax consequences to the partners.

Example 11. Tom and Mary form a partnership for their farming operation. Mary contributes $100,000 of cash and Tom contributes land with a basis of $125,000 and an FMV of $100,000 ($25,000 built-in loss).

In a later year, the partnership sells the land for $120,000. The sale triggers $20,000 of book gain to the partnership ($120,000 sales price – $100,000 FMV at date of contribution), which is allocated $10,000 to each partner. For tax purposes, Tom recognizes a loss of $5,000 (the difference between the partnership's tax basis in the property of $125,000 and the sales price, allocated to him as a built-in loss upon contribution). Mary has a book capital account of $110,000 ($100,000 cash contributed + $10,000 book gain allocated to her). Tom has a book capital account of $110,000, but a tax basis capital account of $120,000 ($125,000 of value contributed – $5,000 tax loss allocated solely to him from the sale). The remaining $20,000 of the built-in loss that Tom has effectively realized on the sale of the property by the partnership is deferred until he sells his interest in the partnership. This distortion is not eliminated by a §754 election because this distortion was created by contributing property to a partnership and not by the sale or redemption of a partnership interest or the death of a partner.

---

103. The IRC §754 election does not change the **net effect** of the partnership life cycle; rather, it eliminates timing and character concerns that could put a buying partner at a disadvantage.

104. IRC §704(c)(1)(C)(i)(ii).

Effect on Depreciable (or Depletable) Property

The basis increase of partnership property as a result of a §754 election, when it is allocated under IRC §755 to partnership property that is depreciable, causes the property to be treated as newly purchased recovery property. Such property is treated as placed in service when a distribution of property occurs (IRC §734(b)) or when the transfer of the partnership interest occurs (IRC §743(b)). The depreciation deductions arising from this "newly acquired" property are allocated entirely to the acquiring partner. Any applicable recovery method and period may be used for this "newly purchased property." There is no change in the computation of the recovery allowance for the balance of the basis. Any basis decrease triggered by §743(b) is accounted for over the remaining recovery period of the affected property, starting with the recovery period during which the distribution occurs.[105] If the basis of depletable property is affected, the change is taken into account in computing the depletion allowance for the property.[106]

Impact on "Bonus" Depreciation. For partnership interests purchased before 2018 or for pre-2018 partnership distributions, the basis adjustment caused by a §754 election failed the "original use" requirement necessary for first-year "bonus" depreciation. This is because the partnership property to which the basis adjustment related was previously used by the partnership and its partners before the sale that gave rise to the adjustment.

TCJA Change. In general, for property placed in service after September 27, 2017, the TCJA increased the amount of the additional first-year depreciation deduction (bonus depreciation) to 100% of the taxpayer's adjusted basis for the qualified property.[107] The TCJA also removed the requirement that the original use of the qualified property had to commence with the taxpayer. Specifically, the additional first-year depreciation deduction became available for "used" property, provided the property was purchased in an arm's-length transaction, was not acquired in a nontaxable exchange (such as a corporate reorganization), and was not acquired from a related person.[108] For purposes of bonus depreciation, IRC §179(d)(2)(A) defines **related person** as the individual's spouse, ancestors, and lineal descendants. Siblings are not related persons for this purpose.

Sale of a Partnership Interest. Under proposed regulations issued in 2018, the partner-specific basis adjustment to partnership property under §743(b) provides that, in determining whether a basis adjustment meets the "used property acquisition requirements," each partner is treated as having owned and used the partner's proportionate share of partnership property.[109] Thus, in the case of a sale of a partnership interest, the requirement that the underlying partnership property was not used by the acquiring partner (or by a predecessor) is satisfied if the acquiring partner has not used the portion of the partnership property to which the basis adjustment relates at any time before the acquisition. It is immaterial that the partnership itself previously used the property.

Similarly, for purposes of applying the requirements that the underlying partnership property was not acquired from a related person:

- The partner acquiring a partnership interest is treated as acquiring a portion of partnership property;
- The partner who is transferring a partnership interest (the seller) is treated as the person from whom that portion of partnership property is acquired; and
- The acquiring partner's basis in the transferred partnership interest may not be determined by reference to the transferor's adjusted basis.

---

105. Treas. Reg. §1.734-1(e)(2).

106. Treas. Reg. §1.612-1(a). For oil and gas property, the basis adjustment is made at the partner level. Treas. Reg. §1.613A-3(e)(6)(iv). For purposes of IRC §734(b), the partnership's adjusted basis in oil and gas property is an amount equal to the partners' aggregate adjusted basis in such property under IRC §613A.

107. IRC §168(k). The property must be placed in service before January 1, 2023. The amount of the deduction is phased down for property placed in service after 2022 and before 2027.

108. These requirements are known as the "used property acquisition requirements."

109. REG-104397-18, 83 Fed. Reg. 39292 (Aug. 8, 2018).

Treas. Reg. §1.168(k)-2(e)(1)(ii)(G) treats the §743 adjustment as a separate class of property. Treas. Reg. §1.168(k)-2(e)(1)(iii)(B) states that the partnership makes the election for the basis adjustments under §743(b). This complicates partnership tax returns by requiring the partnership to ask each partner entitled to a §743(b) adjustment whether the person wants to elect out of bonus depreciation. The election must be made by the partnership, but the partner may not yet know whether bonus depreciation is beneficial for the partner.

Note. The same requirements apply regardless of whether the acquiring partner is a new partner or an existing partner purchasing an additional partnership interest from another partner. So long as the selling partner's specific interest in partnership property acquired by the acquiring partner has not previously been used by the acquiring partner or a predecessor, the corresponding basis adjustment is eligible for the additional first-year depreciation deduction in the hands of the acquiring partner, provided all of the other used property acquisition requirements are satisfied.

Observation. The new rules for used property and bonus depreciation provide a new and significant opportunity for an acquiring partner to deduct the basis of depreciable property held by farm partnerships in one year.

Distribution of a Partnership Interest. The amount of the basis adjustment for a distribution of cash and/or property from a partnership with a §754 election in place to a departing partner in liquidation of that partner's interest in the partnership is treated differently from the basis adjustment as the result of a sale of a partnership interest. This is true even when the adjustment results in an increase to the adjusted basis of partnership property.[110]

The amount of the basis adjustment is equal to the sum of the amount of any gain recognized to the departing partner, and the excess of adjusted basis (in the hands of the partnership) of any property distributed to the departing partner over the basis of the distributed property to the departing partner. The adjustment is made to the partnership property (i.e., non-partner-specific basis). Thus, because the partnership used the property before the distribution giving rise to the basis adjustment, the basis adjustment is ineligible for bonus depreciation.

Making the Election

The §754 election must be made by the partnership before the due date of the partnership income tax return (including extensions) for the year in which the distribution or transfer occurs.[111] No particular form is required for the election, but the election must include the name and address of the electing partnership, a declaration that the partnership elects, under §754, to apply the provisions of §§734(b) and 743(b), and the signature of any partner.[112] The election must be made in a written statement filed with the partnership return for a tax year not later than the year in which the distribution occurs.[113]

---

110. IRC §734(a).

111. An automatic 12-month extension is possible if certain procedural requirements are followed. Treas. Reg. §301.9100-2.

112. Treas. Reg. §1.754-1(b). The IRS proposed regulations in 2017 that would eliminate the signature requirement for a §754 election. This amendment is final when published as a final regulation, but taxpayers may rely upon it for tax years preceding the proposed effective date. The IRS will apparently no longer take the position that the lack of a signature on the election form invalidates the election. See, e.g., *DTDV, LLC v. Comm'r,* TC Memo 2018-32 (Mar. 20, 2018).

113. In Ltr. Rul. 200440013 (May 21, 2004), the IRS granted an extension of time for the filing of the §754 election when a professional tax advisor failed to advise the partnership of the availability of the election. See also Ltr. Rul. 200509017 (Mar. 4, 2005).

Example 12. Use the same facts as **Example 8.** The §754 election was identified on Happy Valley Farm Partnership's Form 1065, *U.S. Return of Partnership Income,* Schedule B, *Other Information,* line 10a. The optional basis adjustment was marked on Form 1065, Schedule B, line 10b, and a statement showing the computation and allocation of the basis adjustment was attached to the return. In addition, the §754 election statement was attached.

	Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts. See instructions		
10a	Is the partnership making, or had it previously made (and not revoked), a section 754 election? . . . . See instructions for details regarding a section 754 election.	X	
b	Did the partnership make for this tax year an optional basis adjustment under section 743(b) or 734(b)? If "Yes," attach a statement showing the computation and allocation of the basis adjustment. See instructions **See Stmt 1**	X	

Form **1065** (2018)

Sample IRC §754 election statement

Election to Adjust the Basis of Partnership Property of Happy Valley Farm Partnership, Farm Avenue, Farm Town

Pursuant to Treas. Reg. §1.754-1(b)(1), the partnership hereby elects to adjust the basis of the partnership property for the tax year ended 12/31/18. Under the provisions of the Internal Revenue Code, this partnership will elect to apply IRC §§734(b) and 743(b).

Statement 1
Form 1065, Schedule B, Line 10b
Optional Basis Adjustment Supporting Detail

Land basis adjustment: $150,000

Allocated to partner Edwin

Before making a §754 election, the following issues should be considered.

- As a general rule, if a partnership has assets that are steadily appreciating (e.g., real estate partnerships) and routinely experiences changes in partnership interests, a §754 election may be advantageous.
- Once a partnership makes a §754 election, the election is irrevocable without IRS permission. There is no guarantee the IRS will permit a partnership to revoke the election.
- An acquiring partner can use 100% bonus depreciation and inventory cost recovery for accelerated deductions.
- Any initial benefit that might flow from the election in the form of increases in the bases of partnership assets during the first year of the election must be weighed against the disadvantage of possible mandatory basis decreases in subsequent years (if the partnership has a substantial built-in loss).[114] Thus, if partnership property **loses value,** a partner who buys an interest for less than the selling partner's share of the inside basis of the property must decrease their share of the inside basis of the partnership property.

[114] Effective for transfers of partnership interests occurring after December 31, 2017, a partnership has a substantial built-in loss, and must make a basis adjustment (even if there is no §754 election in effect) if either (1) the partnership's adjusted basis in its property exceeds its FMV by more than $250,000, or (2) the transferee partner would be allocated a loss of more than $250,000 if the partnership assets were sold for cash equal to their FMVs immediately after the transfer. IRC §743(d)(1)(B).

Example 13. Use the same facts as **Example 5,** except the land held by Happy Valley Farm Partnership loses value from $1.8 million to $1.4 million, the other asset retained a basis and value of $800,000, and Edwin bought Alicia's interest for $550,000 (25% of the total value of $2.2 million). If a §754 election were in place, the partnership would be required to reduce the tax basis of its land (specific to Edwin) by the excess of Edwin's share of the inside basis of the assets ($650,000) over Edwin's outside basis in the partnership interest ($550,000.) As a result, the partnership would actually **decrease** its basis in the land by $100,000, specific to Edwin.

If, instead of land, the partnership assets that decline in value were depreciable property, the depreciation on the resulting $100,000 decrease in inside basis would give rise to negative depreciation deductions (i.e., depreciation deductions that increase Edwin's income).

- Once a §754 election is made, maintaining and managing §§743 and 734 increases or decreases (and the resulting depreciation) can be difficult. This is particularly true when multiple classes of assets are involved and allocations are required under IRC §755, or if a tiered partnership is involved.
- The election increases the recordkeeping burden on the partnership and is tied to the number of assets the partnership holds, the frequency of partnership interest transfers, and types of distributions.
- The benefits of the election do not fall evenly on the partners when partnership interests are transferred. The §743(b) adjustment benefit only transferee-partners. However, if the adjustment is triggered by distributions of partnership property, the adjustment typically affects all partners.

Observation. It may be beneficial to include language in the partnership agreement concerning the §754 election that makes clear the tax implications of transfers of partnership interests.

Observation. A purchaser of a partnership interest should confirm that a partnership has a §754 election in place if the selling partner will have gain in the partnership interest.

Revoking the Election

Once the election is made, it applies to all future transfers unless the election is revoked with IRS permission. A partnership wishing to revoke the election should file a request within 30 days after the close of the partnership year for which the revocation is intended to take effect. The request should state the reason for the revocation.

The following are acceptable reasons for seeking a revocation of the election.[115]

- Change in the nature of the partnership's business
- Substantial increase in partnership assets
- Change in the character of partnership assets
- Increased frequency of retirements or shifts of partnership interests, increasing the administrative burdens of the election

Avoiding potential decreases in the basis of partnership assets is **not** an acceptable purpose for revoking a §754 election.[116]

[115] Treas. Reg. §1.754-1(c).

[116] Ibid.

REPEAL OF TECHNICAL TERMINATION RULE FOR PARTNERSHIPS

The TCJA repealed the "technical termination" rule for partnerships effective for partnership tax years beginning after December 31, 2017.[117] Under the rule, a partnership was considered terminated if within a 12-month period there was a sale or exchange of 50% or more of the total interest in partnership capital and profits. When a technical termination occurred, a partnership could terminate for federal income tax purposes but continue unchanged for legal purposes. With the repeal of technical terminations, partnerships can only terminate for federal income tax purposes if **no part** of any business, financial operation, or venture continues to be conducted by any of the partners in a partnership.[118]

> **Observation.** A change of a majority ownership no longer causes a termination. However, the repeal of the technical termination rule also means certain partnership elections could have a longer impact by limiting the chance for changes to be made.

DEPRECIATION

NONDEPRECIABLE ITEMS ON A FARM OR RANCH

Over time, assets wear out or cease to be useful and their cost, in effect, is consumed during their period of usefulness in the farming or ranching business. In recognition of this cost, the Code allows an annual deduction for depreciation. In addition, in some instances the total allowable depreciation for the asset can be claimed entirely in the first year the taxpayer places the asset into service.[119]

In general, depreciation is allowable on all tangible and intangible property with a limited useful life of more than one year. It is allowable on property used in the trade or business of farming or ranching or held for the production of income. Depreciable property includes business machinery and equipment, buildings, patents, purchased livestock, and property held for rental. Property that is generally not depreciable includes inventories or stock in trade, a building used only as a residence, and an automobile used only for pleasure. Land is not depreciable because it does not have a determinable useful life.

Farmers and ranchers encounter unique situations that raise the question of whether an allowance for depreciation is available. Assets that are sufficiently similar to land may be nondepreciable because they do not have a determinable useful life.

Agricultural-Specific Assets

Agricultural operations can use unique assets that are not depreciable because they do not have a determinable useful life.

Grazing Preferences. In general, grazing preferences are not depreciable or amortizable. In *Uecker v. Comm'r,*[120] the court held that grazing privileges had an indeterminant life because the taxpayers had preferential application and renewal privileges under state and federal law. The privileges were not depreciable under IRC §178 because of the taxpayer's ability to renew them indefinitely.

---

117. See former IRC §708(b)(1).

118. IRC §708(b)(1).

119. IRC §168(k). The property must be placed in service before January 1, 2023. The amount of the deduction is phased down for property placed in service after 2022 and before 2027.

120. *Uecker v. Comm'r*, 81 TC 983 (1983), *aff'd,* 766 F.2d 909 (5th Cir. 1985).

The same result was reached in *Shufflebarger v. Comm'r,*[121] In this case, the taxpayers acquired a portion of a summer allotment of grazing privileges in a national forest. They amortized the cost of acquiring the grazing privileges and deducted the cost. The IRS disallowed the deduction on the basis that the rights had an indefinite duration. The Tax Court agreed.

The same result was reached in *Central Arizona Ranching Company v. Comm'r,*[122] which was a case involving state and federal land leases. In Ltr. Rul. 8327003,[123] the IRS determined that a taxpayer's interest in a state grazing rights lease did not qualify as real property for purposes of a tax-deferred exchange under IRC §1031, but it was not subject to depreciation or amortization deductions under IRC §167. The IRS noted that the terms of the lease were of indefinite duration.

Observation. A different conclusion could be reached if facts reveal that the life of the grazing privilege has a certain endpoint, such as when the rights are dependent on the supply of a natural resource that will eventually be depleted.

Earthen Irrigation Ditches and Levees. In Rev. Rul. 69-606,[124] the IRS ruled that the cost allocated to earthen watering tanks or "ponds" that were constructed by a prior owner on land the buyer leased to ranchers was not recoverable through depreciation because it did not have a determinable useful life. The IRS also ruled the buyer could not recover the allocated cost as a soil and water conservation expense.

The Tax Court concluded similarly in *Wolfsen Land & Cattle Co. v. Comm'r.*[125] In that case, the taxpayer bought a ranch that had an extensive irrigation system on over 17,000 acres. The Tax Court upheld the IRS determination that the system was not depreciable because it had an indeterminant useful life. The Tax Court noted the evidence revealed that consistent repairs would result in the system lasting indefinitely.

Some cases have held dams and ponds to be depreciable if a definite useful life can be demonstrated. For example, in *Rudolph Investment Corp. v. Comm'r*,[126] earthen water tanks and dams were determined to have a 10-year useful life. In Rev. Rul. 75-151,[127] the IRS pointed out that the question of whether dams, ponds, canals, and similar structures are depreciable depends on a factual determination that the asset is actually exhausting and that such exhaustion can be measured.

Note. For farmers and ranchers, a current deduction under IRC §175 is available for expenditures incurred for earthen terraces and dams that are nondepreciable. The qualifications for §175 must be satisfied.

Permanent Pastures. Permanent pasture is generally defined as land used to grow grasses or other forage naturally or through cultivation and is not included in a crop rotation for five years or longer. Permanent pastures have been held to be depreciable. For example, in *Johnson v. Westover,*[128] the taxpayer purchased a ranch that included 200 acres of permanent pasture that had been planted with various grasses about five years earlier. The court determined, based on the evidence, that the pasture should be replanted at the end of 10 years to maintain its economic usefulness. At the time of purchase, the evidence showed the pasture had a remaining life of five years.

---

121. *Shufflebarger v. Comm'r*, 24 TC No. 90 (1955).

122. *Central Arizona Ranching Company v. Comm'r*, TC Memo 1964-217 (Aug. 17, 1964)

123. Ltr. Rul. 8327003 (Mar. 17, 1983).

124. Rev. Rul. 69-606, 1969-2 CB 33.

125. *Wolfsen Land & Cattle Co. v. Comm'r,* 72 TC 1 (1979).

126. *Rudolph Investment Corp. v. Comm'r,* TC Memo 1972-129 (Jun. 12, 1972).

127. Rev. Rul. 75-151, 1975-1 CB 88.

128. *Johnson v. Westover,* 55-1 USTC ¶ 9,421 (S.D. Cal. 1955).

Government Allotments or Quotas. Many farmers participate in federal farm programs. Particularly under prior farm bills, farmers were required to participate in acreage allotments. An acreage allotment is a particular farm's share, based on its historic production, of the national acreage needed to produce sufficient supplies of a particular crop. These allotments have been held to be nondepreciable due to a lack of a determinable useful life.

For example, in *Wenzel v. Comm'r,*[129] the Tax Court addressed whether the peanut base-acreage allotment as part of the federal farm programs was depreciable. The Tax Court noted that while the program had been controversial for some time, it continued to be reauthorized by subsequent farm bills. Thus, the Tax Court determined the peanut program would continue unless Congress took action to terminate it. Because the actions of Congress were unpredictable, the Tax Court held that the peanut program base-acreage allotment was indeterminant and the associated cost to the taxpayer was not depreciable.

Later, in CCA 200429001,[130] the IRS noted that three additional farm bills had become law since the Tax Court's ruling in *Wenzel* and the peanut program continued. This led the IRS to conclude the duration of the peanut program could not be determined with reasonable certainty or accuracy. Consequently, the IRS determined, the peanut base-acreage allotment did not have a determinable useful life and could not be depreciated.

A transferable right to receive a premium price for a fixed quantity of milk in accordance with a regional milk marketing order has been held to be amortizable (e.g., the cost could be spread over the useful life of 15 years)[131] when it has a statutory expiration date and is not expected to be renewed. For example, in *Van de Steeg v. Comm'r,*[132] the taxpayers were dairy farmers who marketed their milk production subject to a federal milk marketing order. On several occasions they purchased an intangible asset (referred to as a "class I milk base") that they used in their dairy business. They claimed depreciation for the milk base and the IRS disallowed the deduction on the basis that the asset had an indeterminable useful life—it depended on whether Congress would extend the program. The Tax Court (affirmed by the Ninth Circuit) held that the program that created the class I milk base always contained an express termination date and the existence of two extensions did not change the fact that a termination date always existed, even though the date had changed.

Note. While the IRS disagrees with the *Van de Steeg* opinion, it announced that it would follow it.[133]

Drilling Costs for Wells. Drilling costs for wells are not depreciable, but parts of wells (e.g., piping and casings) are.[134] However, there is language in a Treasury regulation that indicates wells might be depreciable.[135] In addition, the fact that the IRS has previously ruled that water wells were eligible for the investment tax credit (when it was available) bolsters the argument that water wells are depreciable. To be eligible for the investment tax credit, the property at issue had to be depreciable property.[136]

Landscaping and Land Modification Costs. If a farmer or rancher incurs costs associated with landscaping or modifying the land (dirt moving) to construct a building that will be used in a farming business, the costs are likely depreciable. Support for this position can be found in Rev. Rul. 74-265.[137]

---

129. *Wenzel v. Comm'r,* TC Memo 1991-166 (Apr. 10, 1991).

130. CCA 200429001 (Jul. 16, 2004).

131. IRC §168(c).

132. *Van de Steeg v. Comm'r,* 60 TC 17 (1973), *aff'd* 510 F2d 961 (9th Cir. 1975).

133. Rev. Rul. 75-466, 1975-2 CB 74.

134. See, e.g., Rev. Rul. 56-599, 1956-2 CB 122.

135. See, e.g., Treas. Reg. §1.175-2(b)(1).

136. See, e.g., Rev. Rul. 72-222, 1972-1 CB 17; Rev. Rul. 81-120, 1981-1 CB 20.

137. Rev. Rul. 74-265, 1974-1 CB 56.

Under the facts of the ruling, the taxpayer constructed and operated a garden-type apartment complex on several acres. The surrounding area was landscaped according to an architect's plan to conform it to the general design of the apartment complex. The expenditures for landscaping included the cost of top soil, seeding, clearing and grading, and planting of perennial shrubbery and ornamental trees around the perimeter of the tract of land and immediately adjacent to the buildings. The replacement of the apartment buildings after the expiration of their useful lives would destroy the immediately adjacent landscaping, consisting of perennial shrubbery and ornamental trees. The IRS ruled the perennial shrubbery and ornamental trees immediately adjacent to the apartment buildings were depreciable because the replacement of the buildings would destroy the landscaping. This meant the land preparatory costs could be recovered through depreciation deductions over the established useful life of the apartment buildings.

Logging Roads, Bridges and Culverts. Logging roads, bridges and culverts are depreciable if the taxpayer can establish that the roads have a determinable life. In one instance, the IRS ruled that a road did have a determinable useful life that could be determined by the amount of time it took to harvest trees that were reachable via the road.[138]

Under the facts of the ruling, the taxpayer built roads in order to harvest timber, to transport the logs cut from the timber to its facilities for processing, and to carry out general management activities. The taxpayer wanted to depreciate two of the roads. One road was to be maintained so that the taxpayer could use it for an indefinite period to manage and harvest timber. The IRS ruled the roadbed could not be depreciated, but the associated surface, bridges, and culverts could be because they each had determinable useful lives. The other road was to be abandoned after four years, and the useful lives of all parts of the road (roadbed, surface, bridges, culverts, etc.) would terminate when the timber harvest and reforestation work was completed. Because the road had a determinable life, it could be depreciated.

In *Eldridge v. Comm'r,*[139] the taxpayers were allowed to depreciate paved lots used in a cattle operation. The court based its determination on the fact that the taxpayers maintained the horse barn and associated paved areas primarily for use in their cattle-raising activity. The taxpayers rode the horses housed in the barn to herd cattle from one pasture to another. The Tax Court determined the horse barn was maintained primarily for use in the cattle-raising activity, which was engaged in for profit.

EXPENSE METHOD DEPRECIATION AND STRUCTURES ON THE FARM

For tangible depreciable personal property, all or part of the income tax basis can be deducted currently in the year in which the property is placed in service (defined as when property is in a state of readiness for its intended use in the taxpayer's trade or business) under IRC §179. The §179 deduction can be taken regardless of the time of year the asset was placed in service.[140] The taxpayer can elect to take §179 deductions each year.

The TCJA increased the maximum amount a taxpayer may expense under §179 to $1 million.[141] The TCJA also increased the phase-out threshold amount to $2.5 million for tax years beginning after 2017.[142]

Note. The $1 million and $2.5 million amounts are indexed for inflation for tax years beginning after 2018. For 2019, the maximum amount that can be expensed under the provision is $1.02 million and the phase-out threshold is $2.55 million.[143]

Farm structures present an interesting issue as to whether they qualify for expense-method depreciation. Farm buildings cannot be expensed.[144] Other types of structures may qualify for §179 expensing.

---

138. Rev. Rul. 88-99, 1988-2 CB 33.

139. *Eldridge v. Comm'r,* TC Memo 1995-384 (Aug. 14, 1995).

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

141. Rev. Proc. 2019-08, 2019-3 IRB 347.

142. Ibid.

143. Ibid.

144. IRC §1245(a)(3)(B).

General Availability to Farmers and Ranchers

Expense-method depreciation is potentially available to farmers or ranchers for a wide array of assets. For example, expense-method depreciation can be claimed on machinery and equipment, purchased breeding stock, pickup trucks, business automobiles, tile lines, fences, feeding floors, grain bins, silos, and similar "structures" because these structures are not "buildings."

Eligibility of Farm Structures

In general, tangible property is eligible for expense-method depreciation if it is one of the following.

- IRC §1245 property used as an integral part of manufacturing, production, or extraction
- A facility used in connection with manufacturing, production, or extraction for the bulk storage of fungible commodities
- Is a single-purpose agricultural or horticultural structure as defined in IRC §168(i)(13)[145]

A "building" (or its structural components) is not eligible.[146]

Unfortunately, the term "building" is not defined in §179. The regulations under §1245 specify that language used to describe property in §1245(a)(3)(B) (which includes "a building or structural components") is to have the same meaning as utilized for the (now repealed) investment tax credit (ITC) and associated regulations.[147] The term "building" was defined for ITC purposes as follows:

> *The term building generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, packing, display, or sales space.*[148]

IRC §48(p), even though it was repealed, contains the current, valid definition of a single-purpose agricultural or horticultural structure. That provision (and subsections thereunder) defined property that qualified for the ITC. Tax legislation in 1986 moved that language into §1245 for depreciation recapture purposes. Under that definition, a single-purpose agricultural structure (which is not a farm building) is used for housing, raising, and feeding a **particular type** of livestock and their produce and the housing of the necessary equipment. Structures within this definition include hog houses, poultry barns, livestock sheds, milking parlors, and similar structures. The definition also includes greenhouses constructed and designed for the commercial production of plants and a structure specifically designed and used for the production of mushrooms. Thus, only livestock structures and greenhouses qualify under this category.

145. IRC §1245(a)(3).

146. IRC §1245(a)(3)(B).

147. Treas. Reg. §1.48-1(a).

148. Treas. Reg. §§1.48-1(e)(1)–(2).

IRS and Court Guidance. In the context of the ITC, the IRS and the courts have provided guidance. This guidance remains instructive on where the line is drawn between a building (not eligible for §179) and other structures that are eligible for §179 because they do not meet the definition of a building.

1. On the issue of whether agricultural commodity storage facilities are buildings, in Rev. Rul. 66-89,[149] the IRS set forth two basic criteria for determining what improvements qualify as storage facilities, rather than buildings (for ITC purposes).

   a. The facility must provide storage space but not work space.

   b. The facility must not be reasonably adaptable to other uses.

2. *Catron v. Comm'r*[150] involved a prefabricated Quonset-type structure used in the taxpayers' apple farming business. Two-thirds of the structure was devoted to the selecting, grading, and boxing of apples. The other third of the structure was refrigerated. The refrigerated area was held to **not** be a building. Instead, it was "other tangible property" the taxpayer used in connection with agricultural production.

3. Similar to the rationale applied in *Catron*, the Tax Court, in *Palmer Olson v. Comm'r,*[151] determined that property constitutes a storage facility if it does not include working space.

4. In Rev. Rul. 68-132,[152] the IRS determined that a controlled-temperature facility that provided specialized storage for potatoes (for a potato farmer) was not a building despite its outward appearance. Therefore, it qualified for the ITC. The IRS noted the cleaning, processing, grading, and packaging of the potatoes was carried on in an adjacent building.

5. In Rev. Rul. 71-359,[153] the IRS ruled that a structure used for the storage of raw peanuts in the course of the taxpayer's business of buying peanuts from growers and selling peanuts to manufacturers was not a building.

6. In *Merchants Refrigeration Co. of California v. Comm'r*,[154] a large freezer room in which frozen foodstuffs were stored in cartons or bags was a storage facility and not a building.

7. The Tax Court, in *Central Citrus Co. v. Comm'r*,[155] determined "sweet rooms" that occupied approximately one-sixth of a facility and where fruit was stored subject to controlled atmospheric conditions were not buildings. The Tax Court noted the "sweet rooms" were not reasonably adaptable for other uses.

8. In *Giannini Packing Corp. v. Comm'r,*[156] the Tax Court held that rooms built to cool and preserve fruit were integral parts of the production process of the fresh fruit and were not buildings.

9. In Ltr. Rul. 8227012,[157] the IRS determined that a freezer storage facility for prepackaged food products was a building because it was similar to a warehouse. It was built on a concrete slab, had a roof consisting of structural steel and decking, and was constructed with steel racks from the floor to the ceiling located throughout. It also was not used, the IRS noted, for the bulk storage of fungible commodities.

---

149. Rev. Rul. 66-89, 1966-1 CB 7.

150. *Catron v. Comm'r,* 50 TC 306 (1968), *acq* 1972-2 CB 1.

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

152. Rev. Rul. 68-132, 1968-1 CB 14, modified by Rev. Rul. 71-359, 1971-2 CB 61.

153. Rev. Rul. 71-359, 1971-2 CB 6.

154. *Merchants Refrigeration Co. of California v. Comm'r,* 60 TC 856 (1973), *acq* 1974-2 CB 3.

155. *Central Citrus Co. v. Comm'r,* 58 TC 365 (1972).

156. *Giannini Packing Corp. v. Comm'r,* 83 TC 526 (1984).

157. Ltr. Rul. 8227012 (Mar. 30, 1982).

Hoop Structures. There is no guidance on the eligibility of hoop structures for expensing under §179. Hoop structures generally fit in the category of a general-purpose farm building. At least, that is the likely IRS position. A fact-dependent argument can be made that a hoop structure is used as an integral part of production or is akin to a bulk storage facility used in connection with production. If that argument prevails, a hoop structure is §1245 property with no class life and a 7-year recovery period. In that case, a hoop structure would be eligible for §179 expensing and be eligible for first-year bonus depreciation.

> **Observation.** The key to the hoop structure's status is determining whether it is easily adaptable to other uses. If it is, the structure is properly classified as a building. If it is a general-purpose agricultural building, it does not qualify for §179 expensing. However, farm taxpayers can accelerate deductions for new and used farm buildings using 100% bonus depreciation.

Significant Case. In *Hart v. Comm'r,*[158] the taxpayers grew and processed tobacco on their Kentucky farm. After harvesting the tobacco in the summer, the taxpayers placed the plants over sticks in the field to cure. After the tobacco cured, the taxpayers transported the plants to a tobacco barn where the plants were hung for several months.

The taxpayers acquired a new tobacco barn in 1994. The barn was an enclosed A-frame structure with wooden walls and a dirt floor. The structure had three doors big enough to allow farm machinery to enter and exit. The structure did not have a strong foundation, but the foundation could be strengthened easily. It was not suitable for the storage of grain because of ventilation and cracks. It also had minimal electrical wiring and fixtures, no insulation, and no heating or plumbing. The structure contained a "stripping room" where the taxpayers cured, stripped, graded, baled, and boxed tobacco leaves. The stripping room was enclosed only if the weather was cold.

On their tax return, the taxpayers reported the cost of the tobacco barn as $16,730 and elected to expense $6,750 under §179 and depreciate the balance of the structure's cost over 10 years using the 150% declining-balance method (as a single-purpose agricultural/horticultural structure). The taxpayers' position was that the structure was an asset other than a building used either as "an integral part of manufacturing or production" of tobacco or as "a facility used in connection with manufacturing or production." The IRS, however, claimed that the structure was not entitled to §179 treatment and that its recovery period was 20 years.

The Tax Court upheld the IRS's position, determining the tobacco barn was a building rather than a structure. The Tax Court noted the barn looked like a building and it provided working space for employees beyond what was required to cure tobacco. On that latter point, the Tax Court noted the barn was used for five months out of the year to strip, grade, bale, and box tobacco. The employees did more in the barn than simply hanging tobacco plants for curing. The barn also was not a single-purpose agricultural/horticultural structure as defined in §1245(a)(3)(D) because the taxpayers did not use it exclusively for the commercial production of plants in a greenhouse or for the commercial production of mushrooms.[159] Instead, it was a general-purpose structure that did not satisfy the "specific design" or "exclusive use" tests of Treas. Reg. §1.48-10(c)(1) or the "actual use" test of Treas. Reg. §1.48-10(e)(2). Thus, the barn was a farm building with a 20-year recovery period.

> **Observation.** The significant increase in the §179 amount in recent years, and particularly as a result of the TCJA, makes the determination of qualified assets very important. On a farm or ranch, buildings are not eligible for §179, but if a structure provides storage space for agricultural commodities and cannot easily be adapted to other uses, it may be eligible property.

158. *Hart v. Comm'r,* TC Memo 1999-236 (Jul. 21, 1999).

159. See, e.g., IRC §168(i)(13).

DEPLETION

Depletion is conceptually similar to depreciation. It is a deductible allowance for the exhaustion of mineral deposits, timber, and other natural resources. If a taxpayer has an economic interest in the resource, the cost of the diminishing resource can be recovered through the depletion allowance.

In General

The depletion allowance is claimed either on a cost-per-unit basis or as a percentage of gross income from the disposal of the resource.[160] Cost depletion allocates a pro rata portion of the original cost or investment in the resource to each unit of production. In general, the total projected number of units in the deposit or timber tract (tons, barrels, boardfeet, etc.) is divided into the cost of the resource to obtain the amount of cost that should be deducted for each unit of production sold.[161] Cost depletion is **required** for timber.[162]

Percentage depletion is applicable to all minerals. With percentage depletion, a flat percentage of the gross income from the property each year is treated as the depletion deduction to allow the taxpayer to recover the cost of the minerals/resources. The percentage depletion rates are set forth in IRC §613(b). The percentages range from a maximum 22% for deposits in the United States of sulfur and uranium (and other specified elements such as bauxite and nickel), to 5% for clay used or sold for use in the manufacture of drainage and roofing tile, flower pots, and kindred products.[163]

Observation. The taxpayer has the choice of using the higher of cost depletion or percentage depletion and may make the choice each year. However, special rules apply when the predominant property (by value) is hydrocarbon gas. The depletion deduction under the percentage depletion method cannot exceed 100% of the taxable income from the property computed without the deduction for depletion.

As noted above, percentage depletion is allowed to a taxpayer who has an "economic interest" in the minerals in place. That generally means it is available to an owner or lessee. This raises the issue of what happens if the lessor can terminate the lease on short notice. In that situation, does the lessee still have an economic interest entitling the lessee to a deduction for percentage depletion?

That question was answered in *U.S. v. Swank.*[164] In that case, the lessor owned a coal mine and leased the unmined coal (e.g., mineral interest) to lessees in exchange for a fixed royalty per ton based on the sale of the mined coal at prices the lessee would determine. The lessee mined the coal over an uninterrupted period of several years and the proceeds of the sale of the coal were the only revenue from which the lessees received royalties that were paid to the lessors. The lessor had the right to terminate these leases with 30 days' notice. However, that termination right was never exercised.

The lessee sought to claim a percentage depletion deduction for the cost of the mined coal. The IRS claimed the lessee should not be allowed to take a percentage depletion allowance because the lessor had the right to terminate the lease on short notice. That termination right, the IRS asserted, deprived the lessee of an economic interest. The trial court disagreed with the IRS and the U.S. Supreme Court affirmed. The mere existence of the unexercised right to terminate leases did not destroy the lessee's economic interest in the leased mineral deposits. A deduction based on percentage depletion of the coal deposit was proper.[165]

---

160. IRC §611(a).

161. IRC §612.

162. See IRS Pub. 535, *Business Expenses.*

163. IRC §613(b).

164. *U.S. v. Swank,* 451 U.S. 571 (1981).

165. See also Rev. Rul. 83-160, 1983-2 CB 99; and FSA 1999-927 (date redacted).

The impact of the U.S. Supreme Court opinion in *Swank* is that when a farmer leases a mineral deposit to a lessee to extract the minerals, the farmer should be able to claim a deduction for depletion based on an application of a percentage to the gross royalties received. The tax issues get more complex, however, if the farmer becomes the operator of the mineral deposit.

Depletion of Soil

Soil, sod, dirt, turf, water, and mosses are not included within the terms "all other minerals" for purposes of claiming percentage depletion at 14% under §§613(b)(7). However, soil in place can be subject to depletion under the cost method.[166] While no depletion allowance is generally available for sod, a federal district court in Florida has held that sod was a natural deposit and that the removal of the grass resulted in a loss of the soil for which a depletion allowance could be claimed.[167] Likewise, a taxpayer can take cost depletion of topsoil upon the sale of sod and balled nursery stock when the taxpayer can establish that each cutting removed some part of the natural deposit.[168]

Soil presents some interesting depletion issues. A few of the more common ones follow.

- If a mineral or natural resource deposit is continuously replenished by the decomposition of other plants, no depletion is available.[169]
- Loam is a natural deposit subject to depletion but not percentage depletion.[170]
- Peat is eligible for percentage depletion at a 5% rate, but various types of moss are not.[171] The question, then, is the point at which moss becomes peat moss.
- To be eligible for depletion, peat moss must actually be extracted rather than merely subside.[172]

Depletion of Timber

The sale of standing timber typically triggers capital gain for a farmer-seller.[173] The tax basis in the timber can be recovered either through depletion or by an offset against the selling price. However, if the income from a timber sale is reported as "other income" on Schedule F, timber depletion should be claimed in order to preserve the basis. Alternatively, if the income from timber sales is reported as an item purchased for resale, depletion on the timber should be listed as the cost (or other) basis. There is no line on Schedule F for timber or depletion. This means the taxpayer must indicate how the depletion was computed.

Note. The taxpayer should complete Form T, *Forest Activities Schedule,* to show the depletion computation.

166. Rev. Rul. 78, 1953-1 CB 18.
167. *Flona Corp. v. U.S.,* 218 F. Supp. 354 (S.D. Fla. 1963).
168. Rev. Rul. 77-12, 1977-1 CB 161, revoking Rev. Rul 54-241, 1954-1 CB 63.
169. See, e.g., Rev. Rul. 79-267, 1979-2 CB 243.
170. Rev. Rul. 79-411, 1979-2 CB 246.
171. See, e.g., IRC §613(b)(7)(A).
172. See, e.g., *A. Duda & Sons, Inc. v. U.S.,* 560 F.2d 669 (5th Cir. 1977), *rev'g* 383 F. Supp. 1303 (M.D. Fla. 1974).
173. IRC §631(b).

Depletion of Groundwater

In some parts of the country, the IRS permits a depletion allowance for water deposits in an aquifer beneath the surface. In portions of the Ogallala formation which runs through Western Nebraska and Kansas, eastern Colorado, part of New Mexico, and the panhandles of Oklahoma and Texas, taxpayers are permitted to claim a depletion deduction for water. In these areas, the water is being pumped at a level exceeding the recharge rate for the underlying aquifer. The IRS permits a depletion allowance on water in these areas where it can be shown that the rate of recharge in the underlying aquifer is extremely low. In 1965, the Fifth Circuit Court of Appeals held in *U.S. v. Shurbet* that groundwater in the Ogallala formation in the southern high plains of Texas and New Mexico was a depletable mineral and natural deposit.[174]

> **Note.** The IRS stated it would follow *Shurbet* but would limit the application of the rule to situations similar to those in the southern high plains of Texas and New Mexico where water is extracted from the Ogallala formation.[175]

In late 1982, IRS announced a broadening of the rule in *Shurbet* to areas where it could be demonstrated that the groundwater is being depleted and that the rate of recharge is so low that, once extracted, the "groundwater would be lost to the taxpayer and immediately succeeding generations."[176]

Depletable Property Held by an Estate or Trust

For mineral or timber property held in trust, the allowable deduction for depletion is apportioned between the income beneficiaries and the trustee on the basis of trust income from the property allowable to each unless the governing instrument allows the trustee to maintain a reserve for depletion. If the trust instrument or local law requires or permits the trustee to maintain a reserve for depletion, however, the allowance may be allocated first to the trustee to the degree that income is placed in the depletion reserve. Any excess amount is apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each.[177]

> **Note.** Rev. Rul. 61-211[178] governs the situation in which the trust or estate is entitled to a portion of a depletion deduction from a partnership or another estate or trust.[179]

REVENUE PROCEDURE 2019-33[180]

In August 2019, the IRS issued Rev. Proc. 2019-33, which provides further guidance to taxpayers regarding the election of additional first-year depreciation (hereinafter referred to as bonus depreciation).[181] Specifically, this guidance concerns making a late election, or revoking an election, for certain property acquired after September 27, 2017, and placed in service or planted or grafted by the taxpayer during their tax year that included September 28, 2017.

---

174. *U.S. v. Shurbet,* 347 F.2d 103 (5th Cir. 1965).

175. Rev. Rul. 65-296, 1965-2 CB 181.

176. Rev. Rul. 82-214, 1982-2 CB 115.

177. Rev. Rul. 60-47, 1960-1 CB 250; Treas. Reg. §1.611-1(c)(4).

178. Rev. Rul. 61-211,1961-2 CB 124, modified by Rev. Rul. 74-71, 1974-1 CB 158.

179. See also Rev. Rul. 66-278, 1966-2 CB 243.

180. Rev. Proc. 2019-33, 2019-34 IRB 662.

181. IRC §168(k).

The revenue procedure affects elections under IRC §§168(k)(5), (7), and (10) and is effective July 31, 2019. The revenue procedure provides relief to taxpayers who filed their federal tax returns for the tax year that includes September 28, 2017, prior to the IRS issuing proposed regulations.[182] The proposed regulations provided guidance on changes to bonus depreciation made by the TCJA. A taxpayer may not have had sufficient time to evaluate the proposed regulations and make an informed decision on electing or not electing bonus depreciation.

Elections

IRC §168(k)(5) allows a taxpayer to elect to deduct bonus depreciation for certain plants bearing fruits and nuts (specified plants) planted or grafted by the taxpayer after September 27, 2017. Under §168(k)(5), a taxpayer makes the election for the 2016 or the 2017 tax year by attaching a statement to a timely filed tax return (including extensions) asserting that the taxpayer is electing to apply §168(k)(5) and identifying the specified plant(s) for which the election applies.

A taxpayer may elect under §168(k)(7) **not** to deduct additional first-year depreciation for any class of qualified property the taxpayer places in service during the applicable year. An election statement for §168(k)(7) must state that the taxpayer is electing not to deduct bonus depreciation and the class(es) of property for which the election applies. However, taxpayers who failed to attach the election statement may nevertheless be deemed to have made a §168(k)(7) election as described in Rev. Proc. 2019-33.

IRC §168(k)(10) allows a taxpayer to elect to deduct 50%, instead of 100%, bonus depreciation for all qualified property acquired after September 27, 2017, and placed in service during the 2016 or 2017 tax year. A taxpayer making a §168(k)(5) election for 2016 or 2017 may also make a §168(k)(10) election for the same specified plants. To elect §168(k)(10), a taxpayer must attach a statement indicating that they are electing to deduct 50% bonus depreciation for all qualified property.

Rev. Proc. 2019-33 allows a taxpayer who did not make one or more of the three elections described to make a late election or revoke an election by filing an amended return for the tax year the election is to apply before the federal income return is filed for the next tax year. Alternatively, affected taxpayers may file Form 3115. Form 3115 must be filed with a timely filed federal tax return for any of the first three tax years succeeding the 2016 or 2017 tax year. The designated automatic accounting method change number to report on Form 3115 is 241.

If the taxpayer files a Form 3115, they must calculate a §481(a) adjustment applicable for the first, second, or third tax year succeeding the 2016 or 2017 tax years.[183] Concurrent automatic changes must be combined on a single Form 3115, which must include one §481 adjustment.[184]

Note. For more information on a change in accounting method, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Small Business Issues.

182. REG-104397-18, 2018-41 IRB 558.

183. Rev. Proc. 2019-33, 2019-34 IRB 662 (§7.02).

184. Ibid.

LIKE-KIND EXCHANGES (POST-TCJA)

IRC §1031 allows a tax-deferred exchange of property held for productive use in a business or for investment if the replacement property is like-kind property held for those purposes. Before 2018, the like-kind exchange rules applied to real property, tangible personal property, and certain intangible property. For tax years beginning after 2017, personal property and intangible property are not eligible for §1031. Thus, for exchanges completed after 2017, §1031 is limited to real property exchanges.[185] Like-kind exchanges of personal property are taxable.

Federal income tax law, rather than state law, controls whether exchanged properties are of like kind for purposes of §1031. IRC §§48, 263A, and 1245 are informative as to whether property is real property or personal property for federal income tax purposes.[186]

Observation. The sale of a farm as part of a deferred exchange requires the determination of real versus personal property status. For §1031 purposes, it is necessary to determine if machinery and equipment are structural components to an inherently permanent structure. That status is determined based on whether the structure remains intact if the equipment is removed.

Under Treas. Reg. §1.263A-8(c), real property includes the following.

- Land
- Unsevered natural products of land
- Buildings and inherently permanent structures

Note. Inherently permanent structures include property affixed to real property that will ordinarily remain affixed for an indefinite period, such as swimming pools, roads, bridges, tunnels, telephone poles, broadcasting towers, and storage equipment.

- Machinery that is a structural component to a building or inherently permanent structure

Tangible personal property means any tangible property except land and improvements, including structural components of such buildings or structures. The following are examples of tangible personal property as noted in Treas. Reg. §1.48-1(c).

- Production machinery
- Printing presses
- Transportation and office equipment contained in or attached to a building
- Gasoline pump
- Hydraulic car lift
- Automatic vending machine (even though annexed to the ground)

185. IRC §1031(a)(1).

186. CCA 201238027 (Apr. 17, 2012). In the CCA, the IRS states, "Relying solely on state property classifications can lead to absurd results." Identical property exchanged across state lines would not qualify for IRC §1031 if the property was located in states that classified the property differently.

Example 14. Blanche Carte owns hog confinement facilities consisting of a structure, hopper feeder bins, augers and feeders, and manure storage. The hopper feeder bins, augers, and feeders are designed to function as an integrated unit and can be removed without damage to the integrity of the overall structure. Thus, they are considered personal property.

Blanche also owns a feed handling facility that includes corrugated steel grain silos, an elevator leg with downspouts, dump pit, as well as feed grinding and mixing equipment. Except for the feed grinding and mixing equipment, these assets are real property.

Simply because the TCJA eliminates tax-deferred exchange treatment for tangible personal property does not mean farmers will no longer engage in like-kind exchanges involving property other than real estate. Farmers will still "trade" equipment. However, the tax reporting is handled differently than before the effective date of the TCJA provision. For personal property trades completed after 2017, the trade-in value is listed as the selling price of the "traded" equipment on Form 4797, *Sales of Business Property.*

Observation. The gain reported on the sale (or trade) of personal property is likely ordinary income and is included in QBI. For more information about QBI, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: QBID Update.

Consequently, the entire asset value of the newly acquired property is eligible for bonus depreciation or §179.

Example 15. George, a married taxpayer filing a joint tax return, traded his fully depreciated tractor for a new tractor in 2017 and elected out of bonus depreciation for that class of property. In addition to their farm income, George paid $1,500 in student loan interest in 2017. Based on the pre-TCJA regulations under §1031[187] as applied to trades of tangible personal property, George is trying to get his taxable income down to $75,900 (which is the top of the 15% tax bracket for 2017)[188] and sees no reason to take additional depreciation deductions that would only provide a 10% or 15% income tax benefit. The transaction is treated as follows on George's 2017 return.[189]

187. Treas. Reg. §1.1031(d)-1(a).

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

189. The underlying tax computations supporting the numbers contained in the example were prepared by Mark Dikeman, Associate Director, Kansas Farm Management Program, Kansas State University.

Old Law

Farm income (before depreciation)	$250,000
Old tractor trade allowance	150,000
New tractor trade difference (boot)	250,000
New purchases	$250,000
Less: §179 deduction	(131,053)
Remaining cost	$118,947
7-year 150% DB, half-year convention	× 10.714% [a]
1st year depreciation	$ 12,744
Farm income	$250,000
Less: §179 deduction	(131,053)
Less: 1st year depreciation	(12,744)
Schedule F income	$106,203
4797 gain	$ 0
Schedule F income	106,203
Less: student loan interest deduction	(1,500)
Less: ½ SE tax	(7,503)
AGI	$ 97,200
Less: standard deduction and exemptions	(21,300)
Taxable income	$ 75,900
Income tax (10% & 15%)	$ 10,452
SE tax	15,006
Total liability	$ 25,458

[a] IRS Pub. 946, *How To Depreciate Property.*

Thus, under pre-TCJA law and assuming the goal is to have taxable income at $75,900, the transaction results in no gain being reported on Form 4797, a §179 deduction of $131,053, and 150% declining balance depreciation of $12,744. A self-employment (SE) tax liability of $15,006 generates a deduction for half of that amount. George's total tax liability is $25,458.

Example 16. Use the same facts as **Example 15.** In 2019, George's neighbor, Aaron, who is also a married taxpayer filing jointly, trades his fully depreciated tractor for a **new** tractor, and elects out of bonus depreciation for that class of property. The same dollar values as used in **Example 15** are applied to the trade-in allowance as well as the purchase price of the new tractor. However, the student loan interest Aaron paid was $1,875 rather than $1,500. Because of the TCJA, the transaction no longer qualifies for tax-deferred treatment under §1031,[190] but that does not mean Aaron's tax liability is higher. If Aaron is targeting $75,900 of taxable income, the transaction is reported as follows.

190. IRS News Rel. 2018-227 (Nov. 19, 2018).

Post-TCJA

Farm income (before depreciation)	$250,000
Old tractor trade allowance	150,000
New tractor trade difference (boot)	250,000
New purchases	$400,000
Less: §179 deduction	(249,063)
Remaining cost	$150,937
MACRS 5-year 200% declining balance, half-year	× 20.000% [a]
1st year depreciation	$ 30,187
Farm income	$250,000
Less: §179 deduction	(249,063)
Less: 1st year depreciation	(30,187)
Schedule F loss	($ 29,250)
4797 gain	$150,000
Schedule F loss	(29,250)
Less: student loan interest	(1,875)
Less: ½ SE tax	0
AGI	$118,875
Less: standard deduction	(24,000)
Less: §199A deduction (final QBID)	(18,975) [b]
Taxable income	$ 75,900
Income tax (10% & 12%)	$ 8,720
SE tax	0
Total liability	$ 8,720

[a] IRC §168(e)(3)(B)(vii) as amended by TCJA. TCJA shortens the recovery period over which a taxpayer may deduct costs or other basis from seven to five years for any **new** machinery or equipment.

[b] The QBID calculation consists of the Schedule F loss ($29,250) plus the $150,000 §1245 ordinary gain less the 1/2 of SE tax adjustment to income ($0) = $120,750 × 20% = $24,150. This result is then compared to 20% of taxable income before the QBID deduction ($94,875 × 20% = $18,975). The lesser of these results ($24,150 vs. $18,975) is the final QBID.

In 2019, the transaction results in the $150,000 of the trade allowance for the old tractor being reported as gain on Form 4797. The $400,000 price of the new tractor is fully depreciable and the total depreciation deduction for the year (§179 and MACRS) is $279,250. There is no longer any SE tax on the transaction due to the Schedule F loss. Aaron's AGI is now $118,875. After the standard deduction, the QBID is $18,975 (20% × ($118,875 – $24,000). The applicable income tax rates are now 10% and 12%, and Aaron's final tax liability is $8,720. Thus, the resulting tax liability in 2019 is $16,738 less than George's liability in 2017 ($25,458 – $8,720). This difference is attributable to elimination of SE tax and lower tax rates in 2019. The QBID allowed for a higher AGI and the same taxable income.

Observation. The 2017 transaction resulted in a remaining depreciable basis of $106,203. The 2019 transaction resulted in a remaining depreciable basis of $120,750. The 2019 transaction results in less tax as well as a higher remaining basis.

Observation. The preceding examples illustrate the possible changes in tax liability before and after the TCJA. Depending on circumstances, these changes result from the following factors.

1. Lower income tax rates apply to taxpayers in 2019 than applied to taxpayers in 2017.
2. A QBID was available to the taxpayer in 2019.
3. An accelerated rate of depreciation is available in 2019 on new assets (5-year 200% MACRS for the 2019 asset vs. 7-year 150% DB for the 2017 asset).
4. For 2019, there is a requirement to report and pay tax on the trade-in allowance, whereas in the 2017 example, the gain and tax recognition were deferred. As a result, the 2019 taxpayers had to claim more §179 deduction to achieve their goal of $75,900 taxable income.

IMPACT ON SOCIAL SECURITY BENEFITS

The elimination of §1031 treatment for personal property exchanges completed after 2017 may prevent many farmers from reporting any SE earnings (or a lower amount than under pre-TCJA rules) if they trade farm equipment during the year. For these farmers, one approach is to elect the optional SE method.[191] Thus, even if a loss is reported on the return, the optional method in 2019 allows the taxpayer to "report" $5,440 of SE income.[192] This results in additional SE tax of $832, but allows the taxpayer to show this amount of income for social security retirement purposes. It also creates $5,440 of "earned income" for purposes of claiming the earned income credit or child tax credit.

Observation. A lower amount of SE income can reduce the ability to claim other deductions such as those for retirement plan contributions and SE health insurance and reduce the child tax credit and earned income credit while diminishing the earnings counted towards future social security benefits.

Note. The TCJA expanded §1031 treatment to cover a partnership interest when the partnership has made an election under §761(a) to exclude the entity from partnership treatment under Subchapter K. The partnership interest is then considered an interest in each of the partnership's assets. To the extent that those assets are real property, they are eligible for §1031 treatment.

2018 FARM BILL AND MARKET FACILITATION PROGRAM PAYMENTS

FARM BILL[193]

The 2018 Farm Bill was approved in December 2018 and did not materially change the underlying structure of the 2014 Farm Bill. For example, there is no change to the $900,000 AGI limitation for farm program participation eligibility, nor are all entities that are similarly taxed treated the same under the attribution rule for payment limitation purposes. A farm operating entity must be either a general partnership or joint venture to avoid being restricted to a single payment limit at the entity level. However, the definition of family farm is expanded to include nieces, nephews, and first cousins; thus, those individuals are now eligible to receive farm program payments under the active engagement rules.

191. Instructions for Schedule SE.

192. Ibid.

193. PL 115-334.

The overall payment limit remains at $125,000 per "person," but it does not apply to marketing loan gains or loan deficiency payments. The price loss coverage (PLC) and the agricultural risk coverage (ARC) programs remain. The reference prices for PLC are the greater of the current reference price or 85% of the average of marketing year average price for the most recent 5-year period, excluding high and low prices.

> **Note.** If base acres were not planted to a covered crop from 2009–2017, the base acres will be maintained but the producer is not eligible for any PLC or ARC payments.

A producer may use the old reference price or the effective reference price (ERP). The ERP is updated each year and used in determining if there will be a PLC payment. The ERP is never lower than the current reference price and can never be higher than 115% of the current reference price (from the 2014 Farm Bill). Thus, it is possible for the reference price to increase when prices increase. The ERP is calculated each year based upon 85% of the Olympic average of the marketing year average (MYA) prices for the last five crop years (after eliminating the high and low prices). If this number is higher, it is then compared to 115% of the current reference price. If it is lower, it will be the effective reference price for that crop year. If it is higher than 115%, it will be limited to 115%.

The following table was computed based on estimated values to depict the impact of new price computations in the 2018 Farm Bill.[194]

Crop	Min	Max	85% of Olympic Price	2019 Reference Price	Percent of Old Reference	Percent Needed to Get to Min
Wheat	$ 5.50	$ 6.33	$ 4.17	$ 5.50	100.0%	24.2%
Corn	3.70	4.26	2.99	3.70	100.0%	19.2%
Grain sorghum	3.95	4.54	2.81	3.95	100.0%	28.9%
Barley	4.95	5.69	4.22	4.95	100.0%	14.7%
Oats	2.40	2.76	2.10	2.40	100.0%	12.5%
Long grain rice	14.00	16.10	9.44	14.00	100.0%	32.6%
Medium grain rice	14.00	16.10	9.92	14.00	100.0%	29.1%
Soybeans	8.40	9.66	7.86	8.40	100.0%	6.4%
Peanuts	35.00	40.25	17.91	35.00	100.0%	48.8%
Dry peas	11.00	12.65	9.86	11.00	100.0%	10.4%
Lentils	19.97	22.97	22.33	22.33	111.8%	N/A
Small chickpeas	19.04	21.90	20.06	20.06	105.4%	N/A
Large chickpeas	21.54	24.77	25.87	24.77	115.0%	N/A

Presently, many of the major crops are not close to an adjustment to the reference price. For example, the 85% of wheat Olympic average price would have to rally at least 24% before there would be any adjustment. Unless prices substantially rally and stay at higher levels for at least 2–3 years, there is little chance for any adjustment to the reference prices.

Under the 2018 Farm Bill, PLC payment yields can be updated. The update involves taking the average yield from 2013–2017 over the average yield from 2008–2012, multiplied by the current payment yield. While a producer is locked in to PLC or ARC for 2019–2020, an annual election can be made to change the election for 2021–2023.

ARC is based on physical location of the farm. Data from the U.S. Department of Agriculture (USDA) risk management agency (RMA) has priority. If county lines are crossed, payments are pro-rated based on the acres in each county. In addition, irrigated and non-irrigated payments are calculated for each county.

194. *Likely Only 3 Increases in Reference Price.* Neiffer, Paul. Dec. 11, 2018. CLA Blogs. [blogs.claconnect.com/agribusiness/likely-only-3-increases-in-reference-price] Accessed on Aug. 20, 2019.

Other observations about the 2018 Farm Bill follow.

- Dairy margin coverage is enhanced.
- Conservation reserve program (CRP) acres will increase to 27 million by 2023.
- CRP rates are limited to 85% or 90% of the county average.
- The conservation stewardship program (CSP) is reauthorized. The acre-based funding cap and $18 per acre national average payment rate are eliminated, and the CSP caps spending at $1 billion per year.
- Farm direct ownership loans increased from $300,000 to $600,000 and guarantees increased from $700,000 to $1.75 million.
- Hemp is added as an "agricultural commodity." It is removed from the federal list of controlled substances.
- Whole farm revenue coverage is to be improved (or at least reviewed for improvement).
- No major changes are made to crop insurance, other than new coverage options, etc.

MARKET FACILITATION PROGRAM (MFP)

The MFP is a USDA federal farm program that the Farm Service Agency (FSA) administers. The MFP provides "payments to farmers with commodities that have been significantly impacted by actions of foreign governments resulting in the loss of traditional exports."[195] In September 2018, the first round of MFP payments was authorized. Those payments were paid for various crops as an advance payment of 50% of a producer's final production multiplied by a rate for each crop or commodity. The MFP payment rate for certain commodities follows.[196]

- $1.65 per bushel for certified 2018 soybean production
- $.86 per bushel for sorghum
- $.14 per bushel for wheat
- $.12 per hundredweight for dairy
- $8 per head for pork

A separate $125,000 payment limit ($125,000 for crops and an additional $125,000 for livestock) applied for the 2018 MFP payments. However, these payments were subject to the $900,000 AGI limitation (mentioned earlier). In December 2018, the second round of MFP payments was authorized at the identical 50% rate.

In May 2019, the USDA announced a 2019 MFP payment. This payment is based on a per-acre payment tied to the county where the producer's particular farm is located.[197] However, to be eligible for an MFP payment, a producer must have planted crops. Crop insurance provides payments under the rules applicable to that program for producers that are not able to plant due to weather-related conditions.

---

195. 83 Fed. Reg. 169, p. 44173 (Aug. 20, 2018).

196. *Market Facilitation Program (MFP) Fact Sheet.* USDA FSA. Sep. 2018. [www.fsa.usda.gov/Assets/USDA-FSA-Public/usdafiles/State-Offices/Nebraska/pdfs/MFP%20Fact%20Sheet.pdf] Accessed on Jul. 24, 2019.

197. *USDA Announces Support for Farmers Impacted by Unjustified Retaliation and Trade Disruption.* Jul. 25, 2019. USDA. [www.usda.gov/media/press-releases/2019/07/25/usda-announces-details-support-package-farmers] Accessed on Aug. 7, 2019.

In late July 2019, the USDA announced that sign-up for the 2019 MFP would begin on July 29 and continue through December 6, 2019.[198] Payments are to be issued in up to three separate rounds depending on market conditions and how trade matters develop. The first set of payments was specified to be issued in August 2019. If authorized, the second round of payments is projected to be made in November, with the third set of payments projected for early January 2020.

The USDA noted that commodities eligible for 2019 MFP payments are segregated into "non-specialty crops" and "specialty crops," as well as dairy and hogs.

Non-specialty crops include the following.

- Alfalfa hay, barley, canola, corn, crambe, dried beans, dry peas, extra-long staple cotton, flaxseed, lentils, long grain and medium grain rice, millet, mustard seed, oats, peanuts, rapeseed, rye, safflower, sesame seed, small and large chickpeas, sorghum, soybeans, sunflower seed, temperate japonica rice, triticale, upland cotton, and wheat

Specialty crops include the following.

- Almonds, cranberries, cultivated ginseng, fresh grapes, fresh sweet cherries, hazelnuts, macadamia nuts, pecans, pistachios, and walnuts

To be eligible to receive a 2019 MFP payment, a producer must either have an average AGI for tax years 2015–2017 of less than $900,000, or derive at least 75% of AGI from farming or ranching. With respect to non-specialty crops, the producer must have a share in the crop (such as under a lease agreement) and be either a "person" or legal entity that is "actively engaged in farming."[199]

A producer must also comply with the provisions of the "Highly Erodible Land and Wetland Conservation" regulations, and file Form FSA-578, *Report of Acreage,* with the FSA reporting the **acreage planted for the 2019 crop year** by the "applicable acreage reporting date."[200] Acres not planted in 2019 are not eligible for an MFP payment.

MFP payments are set at the higher of 50% of a producer's "calculated payment" or $15 per acre. However, producers who filed a prevented planting claim and planted an FSA-certified cover crop, **with the potential to be harvested,** are eligible for a $15 per acre payment.

For non-specialty crops, the **producer's calculated payment** is based on a single-county payment rate multiplied by a farm's total acres of MFP-eligible crops in the aggregate in 2019.

Note. The MFP payment is based on the producer's 2019 planted acres of non-specialty crops. However, the acreage amount is limited to 2018 planted acres and prevented planted acres of non-specialty crops.[201] Payments are **not** dependent on which non-specialty crops are planted in 2019. Non-specialty crops, including cover crops, must be planted by August 1, 2019, to be eligible for MFP payments.

198. Ibid.

199. 7 CFR §1409.3.

200. A producer that fails to file an acreage report by the applicable acreage reporting date, must file a "late-filed" acreage report in accordance with FSA procedural rules. A producer that was prevented from planting a crop by the final acreage reporting date must also submit a late-filed report with respect to any CCC-approved cover crop that was planted.

201. The acreage amount is adjusted for acreage that is available for planting as the result of 2018 expired CRP contracts.

For specialty crops, the payment rates are as follows.

- Nuts: $146 per acre
- Cranberries: $.03 per pound at 21,371 pounds per acre
- Ginseng: $2.85 per pound at 2,000 pounds per acre
- Sweet cherries (fresh): $0.17 per pound at 9,148 pounds per acre
- Table grapes: $0.03 per pound at 20,820 pounds per acre

Dairy producers that were operating as of June 1, 2019, are eligible for a $0.20 per hundredweight payment based on production history. Hog producers are eligible for a payment equal to $11 per head based on the number of live hogs owned on a day the producer selects that falls between April 1 and May 15, 2019.

Under the 2019 rules, MFP payments are limited to a combined $250,000 for non-specialty crops **per person or per entity.** MFP payments are also limited to a combined $250,000 for dairy and hog producers and a combined $250,000 for specialty crop producers. However, in no event can a producer receive more than $500,000 in MFP payments for 2019. In addition, a producer who is ineligible for MFP payments under the 2018 MFP rules and who has an average AGI exceeding $900,000, but 75% or more of average AGI derives from farming or ranching, is eligible to receive an MFP payment via a supplemental MFP that is administered during July 29 to December 6, 2019.

MFP payments **cannot** be deferred for income tax purposes. **Crop insurance payments that are paid for the inability to plant or for actual physical destruction to the taxpayer's crops are eligible for deferral.** MFP payments are for lost profit rather than to compensate a producer for physical damage or destruction to a crop, or the inability to plant (the requirement for deferability under IRC §451(f)). Because MFP payments are intended to compensate a farmer for lost profits, they are included in gross income in the year they are received in accordance with IRC §61(a).[202] They are also similar to counter-cyclical and price-loss payments authorized under prior Farm Bills, which a farmer/recipient had to include in gross income. MFP payments must be included in net earnings from self-employment. Therefore, they are subject to SE tax because they are tied to earnings derived by a farmer from the farming business.[203]

RECENT DEVELOPMENTS

FARM INCOME AVERAGING/QBID RELATIONSHIP

Under a farm income averaging election, a farm taxpayer's income tax liability is the sum of the IRC §1 tax computed on taxable income reduced by "elected farm income" (EFI), plus the increase in tax imposed by §1 that would result if taxable income for the three prior years were increased by an amount equal to one-third of the EFI.[204] The IRS has stated that "[i]n figuring the amount [of the]... Qualified Business Income Deduction, income, gains, losses, and deductions from farming or fishing should be taken into account, but only to the extent that deduction is attributable to your farming or fishing business and included in elected farm income on line 2a of Schedule J (Form 1040)." This appears to be saying that if an income averaging election is made, the taxpayer must use EFI to calculate the QBID.[205]

> **Observation.** The IRS guidance appeared to be incorrect as far as the income averaging election is concerned. It is only an election to calculate tax pursuant to a certain method. In many instances, a farm taxpayer would not want to make the election, for example, in situations in which the income in prior years was higher than the current year.

202. See also Rev. Rul. 73-408, 1973-2 CB 15; Rev. Rul. 68-44, 1968-1 CB 191.

203. See, e.g., *Ray v. Comm'r,* TC Memo 1996-436 (Sep. 25, 1996); IRS Legal Advice to Program Managers, PMTA-2018-21 (Dec. 10, 2018).

204. IRC §1301.

205. Apparently, the IRS believed this to be consistent with IRC §199A(c)(3)(A)(ii).

In late May, the IRS removed the initial guidance from its website and replaced it with new guidance.[206] The new guidance indicates that when a farmer calculates the amount of EFI, Schedule F income is reduced by other deductions directly related to farming such as the SE tax deduction. **Thus, the new guidance indicates that a farmer is to reduce EFI by the QBID amount claimed on Form 1040 that is attributable to farm income.**

RECENT CASES

Capitalization

In late 2018, the U.S. Circuit Court of Appeals for the Ninth Circuit affirmed the Tax Court in *Wasco Real Properties I, LLC, et al. v. Comm'r.*[207] The petitioner (three partnerships) bought land that they planned to use for growing almonds. They financed the purchase by borrowing money and paying interest on the debt. They then began planting almond trees. They deducted the interest and property taxes on their returns. The IRS objected to the deduction on the basis that the interest and taxes were indirect costs of the "production of real property" (i.e., the almond trees that were growing on the land).

The Tax Court agreed with the IRS, noting that IRC §263A requires the capitalization of certain costs. Those costs include the interest paid to buy the land and the property taxes paid on the land attributable to growing crops and plants when the pre-productive period of the crop or plant exceeds two years. IRC §263A(f)(1) states that:

> *Interest is capitalized where (1) the interest is paid during the production period and (2) the interest is allocable to real property that the taxpayer produced and that has a long useful life, an estimated production period exceeding two years, or an estimated production period exceeding one year and a cost exceeding $1 million.*

The corresponding regulation, the court noted, requires that the interest be capitalized under the avoided-cost method. The court also noted that the definition of "real property produced by the taxpayer for the taxpayer's use in a trade or business or in an activity conducted for profit" included land and "unsevered natural products of the land." **Unsevered natural products of the land** generally includes growing crops and plants when the pre-productive period of the crop or plant exceeds two years. Because almond trees have a pre-productive period exceeding two years in accordance with IRS Notice 2000-45 and because the land was "necessarily intertwined" with the growing of the almond trees, the interest and tax cost of the land is a necessary and indispensable part of the growing of the almond trees and must be capitalized.

In *Wells v. Comm'r,*[208] the petitioner owned and lived on a 265-acre farm. She had lived there sporadically since 1965, but continuously from 1983 forward. Before the petitioner acquired the property, her father owned it. She cultivated about 700 white French hybrid rind grapevines on a part of the property. In the good years, the vines produced up to four tons of grapes, but in the lean years production could be as low as one-half ton. The petitioner normally sold the grapes, but when production declined, she began crushing the grapes and selling the juice to local buyers. She grazed animals on other parts of the farm. Her gross farm income was $305 and $255 in 2010 and 2011, respectively, and her total farming expenses were $208,265 in 2010 and $54,734 in 2011. Many of those claimed deductible expenses were associated with her grape-growing activity. Upon audit, the IRS denied a large portion of the petitioner's claimed expenses, asserting that they were improvements that should be capitalized.

---

206. *Income Averaging Calculation for Farmers and Fishermen Should Take Into Account the Qualified Business Income Deduction.* May 24, 2019. IRS. [www.irs.gov/forms-pubs/income-averaging-calculations-for-farmers-and-fishermen-should-take-into-account-the-qualified-business-income-deduction] Accessed on Jul. 24, 2019.

207. *Wasco Real Properties I, LLC, et al. v. Comm'r,* No-17-71810, 2018 U.S. App. LEXIS 34267 (9th Cir. Dec. 5, 2018), *aff'g* TC Memo 2016-224.

208. *Wells v. Comm'r,* TC Memo 2018-11 (Jan. 31, 2018).

In 1965, the petitioner's father installed an underground pipe to convey water from a spring on one part of the farm to supply water to a pasture where animals grazed, as well as to irrigate the grapes. Over time, portions of the 2-inch pipe were replaced with new 2-inch pipe that was of higher quality and could withstand higher water pressure. The pipeline was completely replaced in 2009 with new pipe, but then started leaking and a section of it was replaced later in 2009. More leaks occurred in 2010 and additional sections of the pipe were replaced and joints repaired. The court determined that the entire water line was replaced at least one time during 2009 and 2010.

The petitioner claimed that neither the pipeline's useful life was extended nor the value increased. Instead, the petitioner asserted that the pipeline replacement cost was deductible because floods destroyed parts of the pipeline in 2009 and 2010 and she had no other option but to replace the pipeline, and that doing so was simply an accumulation of repairs into 2009 and 2010. She claimed to not have the funds to make repairs in those earlier years.

The IRS maintained that the pipeline "repair" expense was properly capitalized as an improvement, and the court agreed. The court determined that the pipeline work was part of a "general plan of rehabilitation, modernization, and improvement" to completely replace the pipeline. The court noted that the pipeline was completely replaced, its life was extended and its value was increased (because of the use of higher quality pipe). It was immaterial, the court held, that flooding might have destroyed part of the pipeline, leaving replacement as the petitioner's only option. The court noted that an analogous situation was present in *Hunter v. Comm'r,*[209] where the cost of a replacement dam had to be capitalized when the old dam had been washed out by flooding.

The Tax Court also held that costs associated with work on "road maintenance" and around a barn were also not currently-deductible expenses. However, the IRS conceded that $9,000 allocated to repair a culvert, cut trees, and spread manure were currently deductible.

The petitioner also deducted over $16,000 for the construction of a storage yard, including funds for fencing work related to the storage yard. The storage yard did not previously exist. The IRS claimed that the amounts expended to create the storage yard was a capital improvement, which had to be capitalized. The Tax Court agreed. It was new construction on top of previously unimproved land and, as such, was an improvement. The associated costs were not currently deductible.

In 2010, a wildfire burned about 26 acres of the petitioner's property that the petitioner had used, at least in part, for grazing animals. After the fire, it was determined that the fire had made the burned area unable to absorb water. As a result, the petitioner paid to have burned tree stumps removed, along with boulders. The soil of the burned area was cultivated so that the tract could be used for forage. The cost of this work was slightly less than $50,000, which the petitioner deducted on her 2011 return. The IRS denied the deduction claiming instead that the amount was an expense that had to be capitalized as a "plan of rehabilitation."

The Tax Court agreed with the IRS. The evidence, the Tax Court determined, showed that the petitioner had a plan to rehabilitate the burn area, and believed that the expenses would improve the land and its value. In addition, the Tax Court noted that the work on the burn area was extensive and that a large portion of the burn area, before the fire, had no relation to the petitioner's business. After the fire, the petitioner testified that the entire area would be used as forage. Thus, the burn area was adapted for a new use, which meant that the expenses associated with it had to be capitalized.

The petitioner moved for reconsideration under Tax Court Rule 161. In that motion, the petitioner claimed that to the extent the Tax Court had determined that she had incurred capital improvement expenses that constituted new construction, she was automatically entitled to bonus depreciation on those items. The parties discussed the bonus depreciation issue in their computations for entry of decision in accordance with Tax Court Rule 155(b). The IRS asserted that bonus depreciation is only allowed for "qualified property" and claimed that the petitioner had failed to show how the burn rehabilitation area was qualified property. The IRS also claimed that the plaintiff had waived the bonus depreciation issue by failing to raise it earlier. The Tax Court agreed with the IRS and denied the petitioner's motion for reconsideration and determined that the petitioner had waived the bonus depreciation issue.

---

209. *Hunter v. Comm'r,* 46 TC 477 (1966).

On further review of the bonus depreciation issue, the appellate court affirmed.[210] The appellate court also disagreed with the plaintiff's claim that bonus depreciation was a mathematical computation that should have been considered during the Rule 155(b) computation. On the contrary, the appellate court noted that the decision to allow bonus depreciation involves a fact-intensive inquiry that the court could not consider after-the-fact.

Conservation Easement Donation Not Perpetual; Charitable Deduction Denied

The petitioner in *PBBM-Rose Hill, Ltd. v. Comm'r,*[211] owned a tract of land subject to a use restriction that required it to be used only for recreational facilities open space for 30 years. At the time of the petitioner's ownership, the property was a golf course with a clubhouse. The petitioner wanted to sell the property, but before doing so wanted to remove the use restriction. A local buyer expressed interest but also wanted to block any removal of the use restriction. The sale went through after the buyer agreed to allow the removal of the use restriction. However, before the sale closed, the petitioner conveyed a conservation easement of the property to a land trust. The terms of the easement stated that the property was to remain open for public use for outdoor recreation and that fees for such use could be charged. Upon extinguishment of the easement, the land trust would be entitled to a portion of the sale proceeds equal to the greater of the fair market value of the easement at the time of the donation or a share of the proceeds after reduction for expenses of sale and an amount attributable to improvements constructed on the property.

The Tax Court, agreeing with the IRS, denied any charitable deduction for the easement based on its finding that the easement did not protect the conservation purpose under IRC §170(h)(4)(A). Moreover, it did not satisfy the perpetuity requirement of §170(h)(5)(A) because the easement deed's extinguishment provision did not comply with Treas. Reg. §1.170A-14(g)(6). As such, the easement donation was not "exclusively for conservation purposes" as required by §170(h)(1)(C). The Tax Court held that the easement value was $100,000 rather than the $15.2 million that the petitioner claimed. The Tax Court also upheld the gross valuation misstatement penalty that the IRS had imposed.

On appeal, the appellate court affirmed that the petitioner was not entitled to any charitable deduction and upheld the penalty. The appellate court held that when determining whether the public access requirement for a recreation easement is fulfilled, the focus is on the terms of the deed and not the actual use of the land post-donation. The appellate court determined that the terms of the easement satisfied the public-access requirement of Treas. Reg. §1.170A-14S(d)(5)(iv)(C). However, the appellate court concluded that the contribution was not exclusively for conservation purposes because the requirements of Treas. Reg. §1.170A-14(g)(6)(ii) were not satisfied. The deed allowed the value of improvements to be subtracted from the proceeds before the donee took its share. Ltr. Rul. 200836014 no longer represented the current position of the IRS and could not be used to alter the plain meaning of the regulation, which mandates that the donee receive at least the proportionate value of the "proceeds." The appellate court also agreed with the Tax Court that the gross valuation misstatement penalty applied to the difference between the amount the petitioner deducted on its return ($15.2 million) and the $100,000 deduction allowed by the Tax Court.

210. *Wells v. Comm'r,* 18-9007 (10th Cir. 2019), *aff'g* TC Memo 2018-11.

211. *PBBM-Rose Hill, Ltd. v. Comm'r,* No. 17-60276, 2018 U.S. App. LEXIS 22523 (5th Cir. 2018).

No Charitable Deduction for Conservation Easement

In *Pine Mountain Preserve, LLLP v. Comm'r,*[212] the petitioner acquired a tract and later conveyed conservation easements on small portions of the property to a qualified land trust, intending to claim a tax deduction for the value of the contribution pursuant to IRC §170. Each easement set forth a defined area that was to be perpetually restricted from being developed and also specified where "building areas" could occur, all with the stated purpose of protecting natural habitats of fish and wildlife and preserving open space to provide scenic enjoyment to the public. However, the easement conveyed in 2006 did not delineate the location of the building areas, and the easement conveyed in 2005 allowed the petitioner (with the consent of the qualified land trust) to shift the building areas to another location within the conservation area. The 2005 easement also allowed the petitioner to construct barns, riding stables, scenic overlooks, and boat storage buildings in the conservation area. The petitioner claimed charitable deductions for the easements, which the IRS denied on the basis that the easements were not qualified real property interests under §170(h)(1)(A) and were not used exclusively for conservation purposes under §170(h)(1)(C), and that the FMVs of the easements were overstated.

A majority of the full Tax Court agreed with the IRS because the easements did not restrict development on a specific, identifiable piece of property and it appeared that the petitioner could take back the conserved areas and use it for residential developments that were not subject to the conservation easements. As such, the Tax Court determined that the easements did not constitute "a restriction (granted in perpetuity) on the use which may be made of the real property…" The Tax Court, however, pointed out that the easement conveyed in 2007 did cover a specific, identifiable tract and was granted in perpetuity and was made exclusively for conservation purposes and did not reserve in the petitioner any right to construct structures appurtenant to residential development. In addition, the Tax Court noted the language in the 2007 easement providing for amendments did not disturb the qualified nature of the easement because any amendment had to be "not inconsistent with the conservation purposes of the donation."

Note. The Tax Court, in denying the charitable deduction for the 2005 and 2006 easements, followed its decision in *Belk v. Comm'r,*[213] which the Fourth Circuit affirmed.[214] The Tax Court also determined the acceptable boundary modification provisions present in the easements involved in *Bosque Canyon Ranch II, L.P. v. Comm'r,*[215] were distinguishable from those in Belk because they did not allow any of the exterior boundaries of the easements or the acreages to change.

212. *Pine Mountain Preserve, LLLP v. Comm'r,* 151 TC No. 14 (2018).

213. *Belk v. Comm'r,* 140 TC 1 (2013).

214. *Belk v. Comm'r,* 774 F.3d 221 (4th Cir. 2014).

215. *Bosque Canyon Ranch II, L.P. v. Comm'r,* 867 F.3d 547 (5th Cir. 2017).