Chapter 5: Agricultural Issues and Rural Investments

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Please note. Corrections were made to this workbook through January of 2021. No subsequent modifications were made.

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

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Throughout the 2020 *University of Illinois Federal Tax Workbook,* there are topics affected by recent major legislation, notably the Coronavirus Aid, Relief, and Economic Security (CARES) Act of 2020, and the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019. For the reader's convenience in locating these issues, there are icons in the left margin highlighting areas of impact and their source.

CARES Act

SECURE Act

PAYCHECK PROTECTION PROGRAM[1]

Note. Information in this section was current at the time of printing. Paycheck Protection Program details continue to be subject to frequent changes. Please see the 2020 *University of Illinois Federal Tax Workbook* Supplement for the most recent information. This can be found at **uofi.tax/supplement** [taxschool.illinois.edu/downloads.html].

PAYCHECK PROTECTION PROGRAM BACKGROUND

The Paycheck Protection Program (PPP) is an extension of the existing Small Business Administration (SBA) 7(a) loan program for a qualified small business. Many of the existing restrictions on 7(a) loans are waived for a set timeframe, including guarantee and collateral requirements and the requirement that the borrower cannot find credit elsewhere. The purpose of the program is to aid small businesses and help support their payroll during the COVID-19 pandemic. In addition, a small business loan borrower is eligible for loan forgiveness on existing SBA 7(a) loans.[2] The SBA and Treasury issued legislative updates in the form of several Interim Final Rules and a long list of frequently asked questions in April through June 2020.

1. Material in this section is from the May 5, 2020 letter from the American Farm Bureau Federation to the U.S. Small Business Administration re Business Loan Program Temporary Changes and Paycheck Protection Program. Used with permission.

2. *Loan Details and Forgiveness.* U.S. Small Business Administration. [www.sba.gov/funding-programs/loans/coronavirus-relief-options/paycheck-protection-program] Accessed on Jul. 9, 2020.

QUALIFIED SMALL BUSINESS

For purposes of the PPP, a qualified small business is defined as a business in existence as of February 15, 2020, paying employees or independent contractors, that does not have more than 500 employees or the maximum number of employees specified in the current SBA size standards, whichever is greater.[3]

Agricultural businesses are eligible to receive PPP loans. Agricultural businesses are included in the definition in 15 USC §632 of a "small business concern" eligible for an SBA 7(a) loan. In addition, 13 CFR §120.103 allows for a memorandum of understanding between the United States Department of Agriculture (USDA) and the SBA for farm-related business loan programs.

The SBA's Interim Final Rule allows for an agricultural business to be eligible for PPP loans if the business has "500 or fewer employees whose principal place of residence is in the United States, **or** [emphasis added] is a business that operates in a certain industry and meets the applicable SBA employee-based size standards for that industry."[4] As applied to agriculture, the revenue-based size standard is average annual receipts of less than $1 million.[5] Additionally, farms can qualify for PPP loans if they meet the SBA's "alternative size standard." The alternative size standard is currently:[6]

1. A maximum net worth of the business that does not exceed $15 million, and
2. The average net income after federal income taxes (excluding any carryover losses) of the business for the two full fiscal years before the date of the application is not more than $5 million.

Sole proprietorships and self-employed individuals (i.e., independent contractors) may qualify under this program if the sole proprietor/self-employed person has a principal residence in the United States, and the individual filed or will file a 2019 Schedule C, *Profit or Loss From Business*.[7]

Confusion with Interim Final Rule

While the Interim Final Rule only refers to "Schedule C businesses," it seemed that Schedule F, *Profit or Loss From Farming,* should be able to be substituted, particularly because agricultural businesses are eligible for the PPP. The SBA (and the U.S. Treasury Department) later clarified that a farm or ranch business that files Schedule F is clearly eligible.[8]

Note. Some lenders had refused loans based on Schedule F income, citing the Interim Final Rules that refer solely to Schedule C.

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3. *The CARES Act Provides Assistance to Small Businesses.* U.S. Department of the Treasury. [home.treasury.gov/policy-issues/cares/assistance-for-small-businesses] Accessed on Jul. 9, 2020; 13 CFR §120.

4. *Paycheck Protection Program Loans Frequently Asked Questions (FAQs). FAQ#3.* Aug. 11, 2020. U.S. Small Business Administration. [home.treasury.gov/system/files/136/Paycheck-Protection-Program-Frequently-Asked-Questions.pdf] Accessed on Sep. 11, 2020.

5. *Paycheck Protection Program Loans Frequently Asked Questions (FAQs). FAQ#34.* Aug. 11, 2020. U.S. Small Business Administration. [home.treasury.gov/system/files/136/Paycheck-Protection-Program-Frequently-Asked-Questions.pdf] Accessed on Sep. 11, 2020.

6. *Paycheck Protection Program Loans Frequently Asked Questions (FAQs). FAQ#2.* Aug. 11, 2020. U.S. Department of the Treasury. [home.treasury.gov/system/files/136/Paycheck-Protection-Program-Frequently-Asked-Questions.pdf] Accessed on Sep. 12, 2020.

7. 13 CFR §120.

8. *Paycheck Protection Program Loans Frequently Asked Questions (FAQs). FAQ#3, 34.* Aug. 11, 2020. U.S. Department of the Treasury. [home.treasury.gov/system/files/136/Paycheck-Protection-Program-Frequently-Asked-Questions.pdf] Accessed on Sep. 12, 2020.

LOAN ELIGIBILITY

Under the PPP, a lender can lend up to 250% of the lesser of the borrower's **average monthly payroll costs** (before the COVID-19 outbreak) or $10 million (with some exclusions including compensation over $100,000 per person).[9] For example, if the prior year's payroll was $300,000, the maximum loan would be $62,500 ($300,000 total payroll ÷ 12 months × 2.5). The SBA guarantee is 100%.

Self-employed taxpayers became eligible for loans on April 10, 2020.[10] For a self-employed taxpayer, the loan amount is based on the taxpayer's net self-employment (SE) earnings, limited to $100,000 of net SE income. The maximum loan to a self-employed taxpayer is set at 20.8333% (($1 ÷ 12) × 2.5) of SE earnings (plus other payroll costs). The maximum loan amount based on SE earnings is $20,833 ($100,000 × 20.833%).

For a Schedule C taxpayer, net profit is reported on line 31. For a Schedule F taxpayer, net profit is reported on line 34. If line 31 (or line 34 for Schedule F) is a loss, SE earnings are determined to be zero and the PPP loan amount is computed only from payroll costs for employees.[11]

Areas of Uncertainty

While the SBA clarified that Schedule F income can be used for computing loan eligibility, the SBA has taken the position that a loss on line 34 of Schedule F disqualifies the farm/ranch taxpayer from loan eligibility based on earnings. Thus, such a farmer could only qualify for a loan based on employee payroll costs. This is a particularly harsh position as applied to farmers and ranchers.

Under the Tax Cuts and Jobs Act of 2017 (TCJA), effective for tax years beginning after 2017, the manner in which personal property trades are treated on a farmer's tax return is different. Income triggered by the trade is reported on Form 4797, *Sales of Business Property,* and is often offset by increased depreciation on Schedule F. Thus, a farmer's Schedule F income might show a loss, but the farmer may report significant income on Form 4797.

> **Note.** The SBA position is that none of the Form 4797 income from the equipment trade qualifies for loan computation purposes. In recent years, many farmers have not shown positive Schedule F income but do have positive income on Form 4797. Such taxpayers are unable to include equipment gains to create earnings for PPP loan purposes.

For partnerships, filing is at the partnership level. This precludes each partner from receiving a loan relative to income from the partnership. The SBA's position is that a partnership is allowed to count all employee payroll costs for loan computational purposes.[12] In addition, the partnership can count all SE income of partners reported on line 14a of Schedule K/K-1. That amount is then reduced by any IRC §179 expense deduction claimed, unreimbursed partnership expenses claimed, and depletion claimed on oil and gas properties.[13] The result is then multiplied by 92.35% to arrive at net SE earnings, limited to $100,000.

> **Note.** Multiplying the result of the formula by 92.35% for Schedule F farmers is not required.

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9. *Paycheck Protection Program Loans Frequently Asked Questions (FAQs). FAQ#24.* Aug. 11, 2020. U.S. Department of the Treasury. [home.treasury.gov/system/files/136/Paycheck-Protection-Program-Frequently-Asked-Questions.pdf] Accessed on Aug. 10, 2020; *Paycheck Protection Program Borrower Application Form.* [https://home.treasury.gov/system/files/136/Paycheck-Protection-Program-Application-3-30-2020-v3.pdf] Accessed on Sep. 12, 2020.

10. 13 CFR §120.

11. *Paycheck Protection Program Frequently Asked Questions (FAQs) on PPP Loan Forgiveness. Loan Forgiveness Payroll Costs FAQ#8.* Aug. 4, 2020. U.S. Small Business Administration. [www.sba.gov/sites/default/files/2020-08/PPP%20Loan%20Forgiveness%20FAQs%208-4-20-508.pdf] Accessed on Sep. 12, 2020.

12. Ibid.

13. Ibid.

Many farm partnerships have a manager-managed limited liability company (LLC) structure that allows for a reduction in SE tax. Even though this income is considered ordinary income, it is not clear whether such income qualifies for purposes of a PPP loan.

Likewise, if a taxpayer has interests in more than one partnership that are treated as self-employed entities, a question remains as to whether each entity can qualify for a loan. For instance, if a farmer is a partner in three partnerships and earns at least $100,000 of net SE earnings in each partnership, it is unclear whether each partnership uses the farmer's full $100,000 compensation limit or whether it is to be allocated among each partnership.

For an LLC that is taxed as a partnership, the amount a partner receives as a guaranteed payment is taxed as SE income. For taxpayers with interests in multiple single-member LLCs, the taxpayer uses the combined SE income on the 2019 Form 1040, multiplied by 2.5 and divided by 12. However, SBA guidance is not clear on whether if only one entity is profitable, a loan can be filed only for the profitable entity. Similarly, it is not known whether a taxpayer's compensation from each entity is allowed in full (if it does not exceed $100,000 per entity) even though total earnings exceeds $100,000, or whether the taxpayer's compensation is limited to $100,000.

The current SBA position is that S or C corporations are only allowed to use taxable Medicare wages and tips from line 5c of Form 941, *Employer's Quarterly Federal Tax Return.* These wages are subject to Federal Insurance Contributions Act (FICA) and Medicare taxes. If this position applies to filers of Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees,* commodity wages will not be allowed for calculating total employee payroll costs.

Note. Farmers have the unique ability to pay agricultural wages in-kind (i.e., commodity wages) rather than in cash. If the SBA does not allow agricultural commodity wages to count, this will result in some farmers who received an original PPP loan based on commodity wages to have their loan forgiveness reduced.

PAYROLL COSTS

Under the PPP, the loan proceeds can be used for "payroll costs" (up to a per-employee cap of $100,000 of payments of any compensation prorated for the covered period), a mortgage or rent obligation, payment of utilities, and any other debt obligation incurred before the "covered period" (February 15, 2020 – December 31, 2020).[14] However, amounts incurred on "other debt obligations" are not eligible for forgiveness.

Included Costs[15]

Included in the definition of "payroll costs" are the following.

- Salary, wages, commissions, or similar compensation
- Guaranteed payments of a partner in a partnership and a partner's share of income that is subject to SE tax (subject to a per-partner cap of $100,000)
- Cash tips
- Payment for vacation, parental, family, medical, or sick leave
- An allowance for dismissal or separation
- Payments for providing group health care benefits, including insurance premiums
- Payment of retirement benefits
- Payment of state or local tax assessed on the compensation of employees

14. 85 Fed. Reg. 20817 (Apr. 15, 2020).
15. 85 Fed. Reg. 20811 (Apr. 15, 2020).

Excluded Costs

FICA and Medicare taxes and federal income tax withholding are not included in the computation of payroll costs for PPP loan purposes. However, the SBA has subsequently taken the position that the computation should be based on gross payroll.[16] It also does not include any compensation paid to an employee whose principal place of residence is outside the United States, and qualified sick leave and family leave wages that receive a credit under the Families First Coronavirus Response Act (FFCRA).

> **Note.** For information about the FFCRA, see the 2020 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Developments.

Clarity Requested

For purposes of payroll costs, the Interim Final Rules are not clear concerning whether temporary agricultural workers with an H-2A visa qualify as employees if their principal place of residence is in the United States or if they are year-round workers (e.g., dairy workers). Later SBA guidance indicated that an H-2A worker qualifies as an employee upon satisfaction of the principal place of residence test (i.e., at least 183 days present in the United States during the year) as well as when an H-2A worker is present in the United States year-round.[17] Accordingly, it is believed that an H-2A worker's housing also counts as eligible expenses.

LOAN FORGIVENESS

The SBA issued Form 3508, *Paycheck Protection Program Loan Forgiveness Application,* on May 20, 2020. This 11-page document outlines the detailed computations and documentation required to apply for PPP loan forgiveness. The Paycheck Protection Program Flexibility Act (PPPFA) of 2020[18] was signed into law on June 5, 2020. The PPPFA changed some of the rules.

The amount of loan forgiveness for a self-employed taxpayer equals 8/52 (or up to 24/52 at the borrower's election) of the 2019 Schedule C, line 31 (or line 34 of Schedule F) income. Thus, for a loan that is limited to $20,833 ($100,000 maximum loan amount × 20.8333%, as calculated previously) the amount forgiven is $15,385 ($100,000 ÷ 52 × 8). Importantly, it is the borrower's responsibility to request forgiveness.

Practitioner Planning Tip

SE taxpayers should elect a period longer than eight weeks to maximize the computation of owner compensation. This reduces the need to use other expenses that were deemed to be nonqualified by the IRS.

16. *Paycheck Protection Program Loans Frequently Asked Questions (FAQs). FAQ#16.* Aug. 11, 2020. U.S. Small Business Administration. [home.treasury.gov/system/files/136/Paycheck-Protection-Program-Frequently-Asked-Questions.pdf] Accessed on Sep. 12, 2020.

17. *Paycheck Protection Program Frequently Asked Questions (FAQs) on PPP Loan Forgiveness. Loan Forgiveness Reductions FAQ#4.* Aug. 4, 2020. U. S. Small Business Administration. [www.sba.gov/sites/default/files/2020-08/PPP%20Loan%20Forgiveness%20FAQs%208-4-20-508.pdf] Accessed on Sep. 12, 2020.

18. PL 116-142.

Payroll costs incurred during the covered period that are paid after the covered period and on or before the next payroll date are eligible for loan forgiveness.[19]

> **Example 1.** Kay O'Pectate received a PPP loan before June 5, 2020, and elected to use a 24-week covered period. Her covered period runs from Monday, April 20 through Sunday, October 4. She has a biweekly payroll cycle, with a pay period ending on Sunday, October 4. However, Kay will not make the corresponding payroll payment until the next regular payroll date of Friday, October 9. Because Kay incurred payroll costs during the covered period, she may seek loan forgiveness for the payroll costs paid on October 9. The cost was incurred during the covered period and payment was made on the first regular payroll date after the covered period.

Similarly, costs incurred before the covered period that were paid in the covered period are also counted as payroll costs.[20]

The interest rate is set at 1%. Payments, including principal, interest, and fees, can be deferred from six to 12 months, and the SBA will reimburse lenders for loan origination fees.[21] A borrower can then apply for loan forgiveness to the extent the loan proceeds were used to cover payroll costs (at least 60%), mortgage interest, rent, and utility payments during the 24-week period following loan disbursement.[22] Under current legislation, the forgivable portion of non-payroll costs is limited to 40%.

Documentation

> **Note.** Gross rather than net payroll is used in the computation of payroll costs for forgiveness. In addition, only cash compensation is subject to the limit on owner compensation. For S corporation shareholders (and those subject to the family attribution rules), health insurance benefits are considered part of cash compensation and are not an addition to cash compensation as they are for a C corporation shareholder. For a sole proprietor, all of the "extra" payroll costs (retirement benefits, health benefits, and state taxes) for the proprietor are not allowed as deductions in computing Schedule C or F income; such costs are part of the net earnings as shown on Schedule C or F from which the limitation is computed. The compensation of general partners that is eligible for loan forgiveness is limited to 20.8333% of their 2019 net earnings from self-employment that is subject to SE tax.[23]

The borrower must have been in business as of February 15, 2020, and paid employee salaries and taxes or had independent contractors and filed Forms 1099-MISC for them.[24] Guarantee fees are waived, and the loans are nonrecourse to the borrower, shareholders, members, and partners of the borrower. No collateral is required,[25] and the borrower need not show an inability to secure financing elsewhere before qualifying for financing from the SBA.

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19. *Paycheck Protection Program Frequently Asked Questions (FAQs) on PPP Loan Forgiveness. Loan Forgiveness Payroll Costs FAQ#1.* Aug. 4, 2020. U. S. Small Business Administration. [www.sba.gov/sites/default/files/2020-08/PPP%20Loan%20Forgiveness%20FAQs%208-4-20-508.pdf] Accessed on Sep. 11, 2020.

20. *Paycheck Protection Program Frequently Asked Questions (FAQs) on PPP Loan Forgiveness. Loan Forgiveness Payroll Costs FAQ#2.* Aug. 4, 2020. U. S. Small Business Administration. [www.sba.gov/sites/default/files/2020-08/PPP%20Loan%20Forgiveness%20FAQs%208-4-20-508.pdf] Accessed on Sep. 11, 2020.

21. *SBA Procedural Notice.* May 21, 2020. U.S. Small Business Administration. [home.treasury.gov/system/files/136/Guidance-on-PPP-Lender-Processing-Fee-Payment-and-1502-Reporting-Process.pdf] Accessed on Aug. 19, 2020.

22. *Paycheck Protection Program.* U.S. Small Business Administration. [www.sba.gov/funding-programs/loans/coronavirus-relief-options/paycheck-protection-program] Accessed on Jul. 9, 2020.

23. *Paycheck Protection Program Frequently Asked Questions (FAQs) on PPP Loan Forgiveness. Loan Forgiveness Payroll Costs FAQ#8.* Aug. 4, 2020. U. S. Small Business Administration. [www.sba.gov/sites/default/files/2020-08/PPP%20Loan%20Forgiveness%20FAQs%208-4-20-508.pdf] Accessed on Sep. 11, 2020.

24. 13 CFR §120.

25. *Paycheck Protection Program.* U.S. Small Business Administration. [www.sba.gov/funding-programs/loans/coronavirus-relief-options/paycheck-protection-program] Accessed on Jul. 9, 2020.

A borrower under the PPP can apply for loan forgiveness on amounts the borrower incurs after February 14, 2020, in the 24-week period immediately following the loan origination date (e.g., the receipt of the funds) for the following items (not to exceed the original principal amount of the loan).[26]

- Gross payroll costs (not to exceed $100,000 of annualized compensation per employee)
- Payments of accrued interest on any mortgage loan incurred prior to February 15, 2020
- Payment of rent on any lease in force prior to February 15, 2020 (no differentiation is made between payments made to unrelated third parties and related entities (self-rents))
- Payment on any utilities, including payment for the distribution of electricity, gas, water, transportation, telephone, or Internet access for which service began before February 15, 2020

> **Note.** For any PPP loan to be forgiven in full, it must be fully spent on qualifying items, at least 60% of which must cover payroll expenses during the 24-week period following receipt of the loan. It might make sense to keep or rehire staff if needed.

The amount forgiven is **not** considered taxable income to the borrower. Documentation of all payments received under the PPP is necessary to receive forgiveness. For loans issued on or after June 5, 2020, any outstanding amount that is not forgiven is to be repaid over five years, after a 6-month deferral, at a 1% interest rate. For loans issued prior to June 5, 2020, the repayment period is two years. However, for these loans, the borrower and lender may mutually agree to modify the 2-year term.[27]

> **Note.** The CARES Act specifically provided for the nontaxable treatment of PPP loan forgiveness proceeds. However, the IRS later announced that expenses paid with PPP funds that are forgiven are not deductible.[28] This effectively served to negate any tax benefit from the PPP loan.

Current SBA rules require sole proprietors, independent contractors, and other eligible self-employed individuals to provide documentation to the lender that the business was in operation as of February 15, 2020. The SBA rules also provide options for documenting payroll tax filings, including IRS Form 941 (quarterly wages); IRS Form 944, *Employer's Annual Federal Tax Return,* (calendar year wages); state income tax, payroll, and unemployment insurance filings; bank repository accounts; and/or internally generated profit and loss statements.[29]

> **Note.** Agricultural employers report wages, payroll tax liability, and deposits on Form 943. Without guidance, it is not known whether Form 943 also constitutes acceptable documentation of loan forgiveness for agricultural businesses. The 2020 Form 943 is due January 31, 2021. This may be too late to assist in the documentation for PPP loan forgiveness.

26. Ibid; Instructions for SBA Form 3508.

27. *Paycheck Protection Program.* U.S. Small Business Administration. [www.sba.gov/funding-programs/loans/coronavirus-relief-options/paycheck-protection-program] Accessed on Aug. 4, 2020.

28. IRC §265; IRS Notice 2020-32, 2020-21 IRB 837.

29. Instructions for SBA Form 3508.

For loan forgiveness for the self-employed owner, Schedule C (or Schedule F) compensation shown on the 2019 return is used. As mentioned earlier, this amount is then divided by 52 (weeks in the year) and multiplied by eight. The resulting amount is forgiven. It is unclear whether the PPPFA affects this computation.

> **Observation.** With 24 weeks to pay expenses and 10 months for the borrower to request forgiveness, PPP loan amounts could carry over to 2021. Guidance is needed to identify the tax treatment of expenses paid in 2020 for a loan to be forgiven in 2021.

Sole proprietors, independent contractors, and self-employed individuals who had no employees at the time of the PPP loan application and who did not include any employee salaries in the computation of average monthly payroll in the borrower application form automatically qualify to use Form 3508EZ or lender equivalent and should complete that application.[30]

CORONAVIRUS FOOD ASSISTANCE PROGRAM[31]

The Coronavirus Food Assistance Program (CFAP) was created under the CARES Act as a mechanism to reimburse agricultural producers that have suffered a 5% or greater price decline from mid-January 2020 to mid-April 2020, or who had losses due to market supply chain disruptions as a result of governmental actions in response to the coronavirus. The CFAP provides payments for the following.

- Producers of standard program crops (e.g., corn, wheat, soybeans, etc.)
- Dairy producers
- Livestock producers
- Wool producers
- Producers of specialty crops such as fruits, nuts, and vegetables

Crops intended for livestock grazing are ineligible.

> **Note.** Production of the following commodities is not eligible for a CFAP payment: sheep more than two years old, eggs/layers, soft red winter wheat, hard red winter wheat, white wheat, flax, rye, peanuts, feed barley, extra-long staple cotton, alfalfa, forage crops, hemp, and tobacco. The USDA reserves the right to reconsider excluded commodities if credible evidence is provided that supports a sufficient price decline.

30. *Paycheck Protection Program Frequently Asked Questions (FAQs) on PPP Loan Forgiveness. Loan Forgiveness Payroll Costs FAQ#1.* Aug. 4, 2020. U. S. Small Business Administration. [www.sba.gov/sites/default/files/2020-08/PPP%20Loan%20Forgiveness%20FAQs%208-4-20-508.pdf] Accessed on Sep. 11, 2020.

31. *Coronavirus Food Assistance Program.* U.S. Department of Agriculture. [www.farmers.gov/cfap] Accessed on Jul. 9, 2020.

NONSPECIALTY CROPS[32]

Producers with certain types of marketing contracts in existence as of January 15, 2020, are potentially eligible for CFAP payments. **Qualified contracts** for this purpose include basis contracts, basis-fixed contracts, price-later contracts, delayed price contracts, and deferred price contracts. **Ineligible contracts** include cash contracts, fixed price contracts, forward price contracts, cash forward contracts, minimum price contracts, hedge-to-arrive contracts, and futures contracts.

Producers are paid based on inventory subject to price risk held as of January 15, 2020. A payment is made based on the lesser of 50% of a producer's 2019 total production or the 2019 inventory as of January 15, 2020, multiplied by 50% and then multiplied by the commodity's applicable payment rates (as set by the CARES Act).

SPECIALTY CROPS[33]

Producers of specialty crops are eligible for CFAP payments if they have:

- Crops that suffered at least a 5% price decline between mid-January 2020 and mid-April 2020, as a result of the pandemic,
- Produce shipped but subsequently spoiled due to loss of a marketing channel, or
- Shipments that did not leave the farm or mature crops that remain unharvested.

Ineligible specialty crops are those in inventory or storage facilities that were sold after April 15, 2020.

DAIRY

The CFAP payments are available to all dairy producers with milk production in January through March 2020. Likewise, any dumped milk produced during the months of January through March 2020 are eligible for CFAP payments.

Payment is made based on a producer's certified milk production (including dumped milk production) multiplied by $4.71 per hundred weight. Another part of the payment is based on a national adjustment to the producer's first quarter production multiplied by $1.47 per hundred weight.[34]

LIVESTOCK[35]

The CFAP payments are available to a livestock producer that has an ownership interest in eligible livestock and that suffered at least a 5% price decline as a result of COVID-19 and incurred additional significant marketing costs in marketing the inventory of eligible livestock due to an unexpected surplus and disrupted markets. Eligible livestock include cattle (but not beefalo or dairy animals), hogs, and sheep (lambs and yearlings less than two years of age). Payment rates for livestock are based on weight categories.

The livestock CFAP payment is based on two computations.

1. The number of livestock inventory on hand as of January 15, 2020, that were sold between January 15, 2020, and April 15, 2020, including offspring. That number is then multiplied by a payment rate per head.
2. The producer's highest inventory number of eligible livestock between April 16 and May 14, 2020, multiplied by the per head payment rate.

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32. *Coronavirus Food Assistance Program FAQ.* Jul. 1, 2020. U.S. Department of Agriculture. [www.farmers.gov/cfap/faq] Accessed on Jul. 10, 2020.

33. *Specialty Crops and the Coronavirus Food Assistance Program.* U.S. Department of Agriculture. [www.farmers.gov/cfap/specialty] Accessed on Jul. 10, 2020.

34. *Dairy and the Coronavirus Food Assistance Program.* U.S. Department of Agriculture. [www.farmers.gov/cfap/dairy] Accessed on Jul. 10, 2020.

35. *Livestock and the Coronavirus Food Assistance Program.* U.S. Department of Agriculture. [www.farmers.gov/cfap/livestock] Accessed on Jul. 10, 2020.

WOOL PRODUCERS[36]

Wool producers who have suffered a 5% or greater price decline due to COVID-19 and who face increased marketing costs for their inventory are eligible for CFAP payments. Payments are based on inventory, subject to price risk as of January 15, 2020.

A single CFAP payment will be made to wool producers based on the **smaller** of the following **units.**

- 50% of the producer's 2019 total commodity production
- The producer's 2019 commodity unpriced inventory held as of January 15, 2020

The CFAP payment per commodity is calculated as:

(Units × 50% × CARES rate) + (Units × 50% × Commodity Credit Corporation (CCC) rate)

Eligible wool producers are required to furnish proper documentation to verify units of commodity production.

> **Note.** The CARES rates and CCC rates are available at **uofi.tax/20a6x1** [farmers.gov/cfap/wool].

PAYMENT LIMITATION

The payment limitation applicable to CFAP payments is $250,000 per person and legal entity. Entities that limit liability (corporations, LLCs, and limited partnerships) may receive up to $750,000 of CFAP payments based on the number of shareholders (or members not exceeding three) who contribute at least 400 hours of active personal management or active personal labor.

> **Note.** The per person payment limit of $250,000 is applied before any corporate payment limit. The maximum amount that any person can qualify for on a direct and indirect basis is $250,000.

Eligible producers receive 80% of the maximum total payment for which they are eligible, up to the payment limit, upon approval of the CFAP application. The balance is paid at a later date that depends on funds availability and is also subject to the payment limit.[37]

NON-DEFERABILITY OF CFAP PAYMENTS

Under IRC §451(f), a farmer on the cash method of accounting may elect to include crop insurance proceeds and disaster payments (as well as payments for inability to plant) received on account of physical damage or destruction to crops in income in the year following the year of crop loss if the farmer's normal business practice would be to defer the reporting of income from the crops into the following year. CFAP payments are a type of "disaster" payment that could potentially qualify for deferral. However, a CFAP payment is likely tied to the price of the associated crop rather than actual "destruction or damage" to the crop as the Code requires for deferability. While a CFAP payment for a specialty crop could be related to physical damage or destruction to the crop, it is more likely that such a payment may actually be for nondeferrable market damages, or that the crop is actually sold in the year after harvest (which eliminates the possibility of deferability under §451(f)).

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36. *Wool and the Coronavirus Food Assistance Program.* U.S. Department of Agriculture. [www.farmers.gov/cfap/wool] Accessed on Aug. 4, 2020.

37. *Coronavirus Food Assistance Program FAQ.* Jul. 1, 2020. U.S. Department of Agriculture. [www.farmers.gov/cfap/faq] Accessed on Jul. 10, 2020.

NET OPERATING LOSSES

OVERVIEW

In the event a farmer or rancher is confronted with a situation in which expenses exceed income from the business, an operating loss may result. Losses incurred in the operation of farms and ranches as business enterprises as well as losses resulting from transactions entered into for profit are deductible from gross income. A net operating loss (NOL) may be claimed as a deduction for individuals and is entered as a negative amount on Form 1040 in arriving at adjusted gross income (AGI).

PRE-2018 RULES[38]

Before the TCJA (i.e., before 2018), a farming NOL could be carried back five years or, by making an irrevocable election, a farmer could forgo the 5-year carryback and carry the loss back two years (or three years for a loss attributable to a federally declared disaster).[39] When a farmer elected to waive the 5-year carryback, the 2-year carryback generally applied. A **farming NOL** is defined as the lesser of the NOL applicable for the tax year considering only income and deductions attributable to the farming business, or the NOL for the tax year.

A beneficial aspect of the loss carryback rule is that a loss that is carried back to a prior year offsets the income in the highest income tax bracket first, and then the next highest, etc., until it is used up.

Note. Determining whether a loss should be carried back two years instead of five depended on the farmer's level of income and the applicable tax bracket in those carryback years.

Practitioner Planning Tip

A beneficial rule can apply when an NOL is carried back to a prior year. Because two years back (as opposed to the 5-year carryback that applied under pre-TCJA rules) involves an open tax year, any IRC §179 election that was made can be revoked if the loss carryback eliminates the need (from a tax standpoint) for the election. By revoking the §179 election, the taxpayer restores the income tax basis (to the extent of the election) for the item(s) on which the §179 election was made. This allows the taxpayer to claim future depreciation deductions. This is the case, at least, on the taxpayer's federal return. Some states decouple from the federal §179 provision.

38. Adapted from *Farm NOLs Post-2017*. McEowen, Roger. Mar. 19, 2020. Law Professor Blogs Network. [lawprofessors.typepad.com/agriculturallaw/2020/03/farm-nols-post-2017.html] Accessed on Jul. 8, 2020. Used with permission from the Law Professor Blog Network.

39. IRC §§172(b)(1)(E) and (F) prior to being stricken by the TCJA §13302.

Under the pre-2018 rules, taxpayers could elect to forgo an NOL carryback in favor of a carryforward (for 20 years). However, if a taxpayer elected not to carry an NOL back to offset income in prior years, the taxpayer was limited to carrying the NOL forward.

For tax years beginning before 2018, farm losses and NOLs were unlimited unless the farmer received a CCC loan. In that case, farm losses were limited to the greater of $300,000 (or $150,000 for married filing separately (MFS) taxpayers) or net profits over the immediately preceding five years. Any excess losses are carried forward to the next year on Schedule F (or related form).

NOL Computation[40]

The NOL carried over from other years may not be used in calculating the NOL for the year in question. In addition, capital losses may not exceed capital gains. Nonbusiness capital losses may not exceed nonbusiness capital gains, even though there may be an excess of business capital gains over business capital losses. In addition, no deduction may be claimed for a personal exemption or exemption for dependents, and nonbusiness deductions (either itemized deductions or the zero-bracket amount) may not exceed nonbusiness income. Deductions may be lost for a home office, individual retirement account (IRA) contributions, and health insurance costs.

POST-2018 TAX YEARS

The TCJA made changes to how farmers can treat NOLs. For tax years beginning after 2017 and before 2026, a farm taxpayer is limited to carrying back up to $500,000 married filing jointly (MFJ) of NOLs. NOLs exceeding the threshold must be carried forward as part of the NOL carryover to the following year.

Under the TCJA, for tax years beginning after December 31, 2017, NOLs can only offset 80% of taxable income (the former rule allowed a 100% offset). Technically, the **NOL deduction is limited to the lesser of:**

- The aggregate of NOL carryforwards and carrybacks to the tax year, or
- 80% of taxable income computed for the tax year without regard to the NOL deduction allowed for the tax year.[41]

> **Note.** These rules were revised by the CARES Act, as discussed later in this section.

Carryback Issues

Effective for tax years **ending after** December 31, 2017, NOLs can no longer be carried back five years (for farmers) or two years (for nonfarmers). Instead, under the TCJA, farmer NOLs can only be carried back two years. Nonfarmers cannot carry back NOLs. As noted earlier, NOLs that are carried back can only offset 80% of taxable income. However, NOLs that are carried forward will not expire after 20 years (as they did under prior law). Similar to the carryback rule, NOLs that are carried forward can only offset 80% of taxable income.

> **Note.** These rules were changed by the CARES Act, as discussed later.

40. Treas. Reg. §1.172-5; IRS Pub. 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts*.

41. IRC §172(a).

An individual taxpayer claiming a tax refund from an NOL carryback has the option of filing either Form 1045, *Application for Tentative Refund,* or Form 1040X, *Amended U.S. Individual Income Tax Return*. The IRS instructions can be helpful in determining the best approach. IRS transcripts and statements of account to verify the amounts reported for previous years can be helpful when preparing either form. The Form 1045 and 1040X instructions contain detailed lists of attachments to be included with each form. In addition, Schedule A — NOL of Form 1045 computes the NOL, and this schedule must be included with the carryback claim.

Note. For information about completing Schedule A — NOL, see the 2020 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Net Operating and Excess Business Losses.

If the taxpayer has multiple carrybacks to a tax year, taxable income is reduced (without regard to the NOL deduction) in the carryback year in the order in which the losses were incurred, starting with the earliest year. After deducting an NOL, the resulting taxable income is used to determine the deductibility of any remaining NOL.

Caution. When calculating a refund claim for an NOL carryback year, the applicable law is the tax law in effect for the carryback year, not the tax law in effect for the NOL year.

Once the amount of the NOL deduction after carryback is determined for the carryback year, the AGI that results after applying the NOL deduction is then used to recompute income or deduction items that are based on, or limited to, a percentage of AGI.

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

Carryover of Unused NOL Carryback

The amount of unused NOL carryback available for carryover requires determination of the taxpayer's **modified taxable income** for the carryback year. Modified taxable income for this purpose is defined as the taxpayer's taxable income with certain modifications.[42] Any items that are affected by the taxpayer's revised AGI after making some of the modifications must be recalculated using the revised AGI. The calculation can be accomplished using Form 1045, Schedule B — NOL Carryover.

An unused NOL is the sum of the following.

- Any farming loss less the amount of the farming loss that is deemed to be carried back
- Any nonfarm NOL
- Any excess business loss (EBL) for the NOL year

Note. Procedurally, the unused NOL is carried forward to the first tax year after the NOL year. Any NOL not utilized in that year is carried forward to the next year and so on until the NOL is fully utilized.

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42. See Treas. Reg. §1.172-5; IRS Pub. 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts.*

Individual taxpayers report their NOL carryover as a negative amount on the "other income" line of Schedule 1, *Additional Income and Adjustments to Income.* Estates and trusts include an NOL deduction on Form 1041, *U.S. Income Tax Return for Estates and Trusts* (line 15b, for 2019).

For each NOL carryover, taxpayers should attach a statement to their tax return showing how the NOL deduction was calculated as well as important facts about the NOL.

Marital Status Changes[43]

Additional rules apply if a taxpayer's marital status is not the same for all years involved with an NOL carryback/carryforward. In that case, only the spouse who incurred the loss can claim the NOL deduction. Moreover, for years when the couple file jointly, an NOL deduction is limited to the income of the spouse to whom it belongs. Therefore, a taxpayer filing a 2020 joint return with their spouse who later divorces can only carry back an NOL from a future year to offset their share of the taxable income reported on the 2020 joint return. Additionally, the refund for a person filing an NOL carryback claim against a joint return with a former spouse may be limited.

On a joint return, the NOL carryback deduction is limited to the income of the spouse with the loss. Also, the refund for a divorced person claiming an NOL carryback against a joint return with a former spouse cannot be more than the taxpayer's contribution to taxes paid on the joint return. The Code sets forth a step-by-step procedure to use to calculate the portion of joint liability allocated to the taxpayer with the NOL carryback. There are **two limitations** that apply in this regard.

The **first limitation** is determined by a 2-part calculation. This limits the amount of the tax refund to:

1. The taxpayer's contribution to the taxes shown on the original joint return, **minus**
2. The taxpayer's share of the recalculated tax after the NOL carryback.

The **second limitation** is that the taxpayer's refund cannot exceed the total refund calculated on the joint return after the carryback.

There are five steps for calculating the taxpayer's share of the redetermined joint tax liability after the NOL carryback.

1. Determine the taxpayer's total tax as though the taxpayer had filed separately from their spouse.
2. Determine the spouse's total tax as though the spouse had also filed separately from the taxpayer.
3. Add the amounts in steps (1) and (2).
4. Divide the amount in step (1) by the amount in step (3).
5. Multiply the recalculated tax on the joint return by the decimal fraction calculated in step (4). This is the taxpayer's share of the recalculated joint tax liability.

If the married couple does not have an agreement or clear evidence of each spouse's contributions toward the payment of the joint tax liability, then the taxpayer calculates their contribution by summing the tax withheld on their wages and their share of joint estimated tax payments or tax paid with the original return. If the original return for the carryback year resulted in an overpayment, the taxpayer reduces their contribution by their share of the tax refund. The taxpayer's share of a joint payment or refund is determined using the same method used in calculating the taxpayer's share of the joint tax liability. The taxpayer's taxable income as originally reported on the joint return is used in steps 1 and 2, and the joint payment or refund is substituted for the recalculated joint tax in step 5.

The IRS requires the taxpayer to attach a statement to the amended return for the NOL carryback year showing how the refund was calculated using this methodology.

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

Change in Filing Status[44]

Special rules apply in calculating NOL carrybacks/carryforwards for couples who are married to each other throughout the subject NOL year, but who use a mix of MFJ and MFS filing statuses on returns in the carryback or carryforward years. A married couple who files jointly in the NOL year **and** the NOL carryback or carryover year treats the NOL deduction as a joint NOL. If instead the couple files separately in the NOL year and the NOL carryback/carryover year, then the spouse who sustained the loss takes the NOL deduction on their separate return.

When a married couple's filing status differs between the NOL year and the NOL carryback or carryover year, special rules apply. If the couple filed separate returns in the NOL year but jointly in the carryback or carryforward year, then a separate NOL carryback/carryover is treated as a joint carryback/carryover to the carryback/carryover year. If the couple filed jointly in the NOL year but file separate returns in the carryback or carryforward year, then any joint NOL carryback/carryover is apportioned between the spouses based on the NOLs that would have resulted if the couple had filed separate returns in the NOL year.

1. For the NOL year, each spouse's NOL is determined as though the couple filed separate returns. If only one spouse has an NOL, all of the joint NOL is that spouse's NOL.
2. If both spouses have an NOL, spouse A's NOL is determined using the following formula.

$$\textbf{Spouse A's NOL} = \frac{\textbf{Spouse A's NOL calculated in step 1} \times \textbf{Joint NOL}}{\textbf{Sum of the spouses' NOLs calculated in step 1}}$$

3. Spouse B's NOL is then the joint NOL less spouse A's NOL.

Example 2. Matt and Naomi are married and filed separately in 2018. For 2020, they file a joint return, which has a $10,000 NOL from a farming business. Calculated separately, Naomi's 2020 deductions exceeded her income, whereas Mark's income exceeded his deductions. Therefore, the entire $10,000 NOL on their 2020 return is Naomi's, which she can carry back to her 2018 separate return.

Example 3. Use the same facts as **Example 2,** except in 2020 both Matt and Naomi had deductions in excess of their income. Calculated separately, Matt's NOL is $3,500 and Naomi's NOL is $6,000. The sum of their separate NOLs ($9,500) is less than their $10,000 joint NOL because Matt's deductions included a $500 net capital loss that is not allowed in calculating his separate NOL but is allowed in calculating their joint NOL because it was offset by Naomi's capital gain.

Therefore, Matt's share of their $10,000 joint 2020 NOL is $3,684 ($10,000 joint NOL × ($3,500 Matt's NOL ÷ $9,500 sum of separate NOLs). Naomi's share is the remaining $6,316 ($10,000 − $3,684).

NOLs and Death

An NOL that has been carried forward is deductible on a decedent's final income tax return. It cannot be carried over to a decedent's estate. Also, an NOL of a decedent cannot be carried over to subsequent years by a surviving spouse.

44. Ibid.

2020 CHANGE IN NOL RULES

On March 27, 2020, the president signed the CARES Act into law. The CARES Act contains multiple parts. One of those parts contains income tax changes, including changes to the NOL and EBL rules under the TCJA.

The CARES Act amends IRC §172(b)(1) to provide for a carryback of any NOL arising in a tax year beginning after December 31, 2017, and before January 1, 2021, to each of the **five** tax years preceding the tax year in which the loss arises. Thus, for tax years beginning after 2017 and before 2021, a 5-year carryback of NOLs is allowed for all taxpayers, farm and nonfarm.

Observation. The CARES Act delays the 80% EBL limitation of present law until 2021. C corporations can elect to file for an accelerated refund to claim the carryback benefit. For tax years beginning after December 31, 2020, a taxpayer is eligible for a full NOL deduction attributable to tax years before 2018, and an 80% of modified taxable income for NOLs arising in tax years after 2017.[45]

A taxpayer can complete the NOL carryback and tax refund process by filing amended returns (Form 1040X). Alternatively, corporations can apply for a tentative refund using Form 1139, *Corporation Application for Tentative Refund,* and taxpayers other than corporations can use Form 1045. Generally, a Form 1139 or Form 1045 must be filed within 12 months of the close of the tax year in which an NOL arises to apply for a tentative refund based on the NOL carryback. Thus, for taxpayers with NOLs arising in tax years beginning on or after January 1, 2018, and ending before March 27, 2019, the deadline to file an application for a tentative refund as a result of the carryback of such NOLs had expired by the time the CARES Act was enacted on March 27, 2020.

The IRS addressed this issue in Notice 2020-26.[46] In the notice, the IRS grants a 6-month extension of time for taxpayers to file Form 1139 or Form 1045 to apply for a tentative refund from the carryback of an NOL that arose in a tax year that began during the calendar year 2018, and that ended on or before June 30, 2019. The extension of time is limited to requesting a tentative refund to carry back an NOL and does not extend the time to carry back any other item.

Example 4. Stan Theman carried back an NOL arising in a tax year ending on December 31, 2018. Under IRS Notice 2020-26, Stan had until June 30, 2020, to timely file Form 1139 or Form 1045 (as applicable). If he files after June 30, 2020, the Form 1139 or 1045 will be rejected, and Stan will be instructed to file amended returns for each applicable tax year in the 5-year carryback period.

Note. Form 1045 can be faxed to the IRS at 844-249-6237 and Form 1139 can be faxed to 844-249-6236.[47] Under IRS Notice 2020-26, a taxpayer must file the form no later than 18 months after the close of the tax year in which the NOL arose (i.e., no later than June 30, 2020, for a tax year ending December 31, 2018) and write on the top of the form "Notice 2020-26, Extension of Time to File Application for Tentative Carryback Adjustment." If the deadline was missed, an amended tax return must be filed.

45. CARES Act, §2303(b).

46. IRS Notice 2020-26, 2020-18 IRB 744.

47. *Temporary procedures to fax certain Forms 1139 and 1045 due to COVID-19.* Jun. 29, 2020. IRS. [www.irs.gov/newsroom/temporary-procedures-to-fax-certain-forms-1139-and-1045-due-to-covid-19] Accessed on Jul. 10, 2020.

As implied in the text above and in **Example 4, the 2-year NOL carryback is no longer available for farmers for 2018 through 2020.** The 2-year carryback provision was overridden by the CARES Act, and there is no authority for the IRS to allow a 2-year carryback. For NOLs arising in 2018–2020, the general carryback is to each of the five tax years preceding the tax year in which the loss arises. Presently, there is no relief for a farmer who elected to forgo the 2-year carryback so that the 5-year carryback can be utilized.

In Rev. Proc. 2020-24,[48] the IRS provided additional guidance on the treatment of NOLs under the CARES Act provisions. It extended the deadline for filing an application for a tentative carryback adjustment under IRC §6411 to carry back an NOL that arose in any tax year that began during calendar year 2018 and that ended on or before June 30, 2019. Under the guidance, an election to waive the IRC §172(b)(3) carryback for NOLs arising in tax years beginning in 2018 or 2019 must be made no later than the due date, including extensions, for filing the taxpayer's federal income tax return for the first tax year ending after March 27, 2020.

A taxpayer makes the election by attaching to its federal income tax return filed for the first tax year ending after March 27, 2020, a separate statement for each of the tax years 2018 or 2019 for which the taxpayer intends to make the election. The election statement must state that the taxpayer is electing to apply §172(b)(3) under Rev. Proc. 2020-24 and the tax year for which the statement applies. For an NOL arising in a tax year beginning **after** December 31, 2019, and **before** January 1, 2021, an election must be made no later than the due date, including extensions, for filing the taxpayer's federal income tax return for the tax year in which the NOL arises. The election is made by attaching a statement to the return.

Observation. Calendar-year taxpayers have until October 15, 2021, to make this election.

Nothing in the CARES Act addressed how to handle carrying losses back into years when the alternative minimum tax (AMT) applied.[49] Thus, a question existed as to how to compute the alternative tax NOL (ATNOL) for tax years 2018–2020 to tax years before 2018 in the carryback period. In late May, the IRS posted guidance on its website in the form of questions and answers regarding the carryback of NOLs for corporations into years when the AMT applied in light of the CARES Act.[50] Question and answer numbers 1 and 2 of the guidance are key.

> *Q1. A C corporation with an NOL arising in a taxable year beginning after December 31, 2017..is carrying back all or a portion of that NOL to a taxable year beginning before January 1, 2018... For purposes of determining the C corporation's alternative minimum taxable income in the pre-2018 year, what should be the amount of alternative tax net operating loss (ATNOL) arising in the post-2017 year?*
>
> *A1. For Forms 1120X, Amended U.S. Corporation Income Tax Return, or 1139, Corporation Application for Tentative Refund, filed on or after June 1, 2020, treat the ATNOL amount arising in a post-2017 year as zero. The processing of the C corporation's refund may be delayed if it uses a different method to determine the amount of its ATNOL.*
>
> *Q2. A C corporation has already filed amended returns or a claim for tentative carryback adjustment carrying back an NOL from a post-2017 tax year to pre-2018 years, but did not treat the ATNOL for the post-2017 year as zero. Is the C corporation required to take any action...?*
>
> *A2. The C corporation does not need to take any action, or refile a Form 1120X or Form 1139 that was filed before June 1, 2020, unless contacted by the IRS.*

48. Rev. Proc. 2020-24, 2020-17 IRB 750.

49. The TCJA repealed the corporate AMT beginning in 2018.

50. *Questions and Answers about NOL Carrybacks of C Corporations to Taxable Years in which the Alternative Minimum Tax Applies.* May 27, 2020. IRS. [www.irs.gov/newsroom/questions-and-answers-about-nol-carrybacks-of-c-corporations-to-taxable-years-in-which-the-alternative-minimum-tax-applies] Accessed on Jun. 26, 2020.

Note. This change in the AMT calculations will lead to an increase in the minimum tax credit for years when the carryback leads to an increased minimum tax liability — a credit that will likely end up being refunded. Under the TCJA, such ATNOLs will eventually be absorbed in a later year or fully refunded. The CARES Act accelerates those refunds, allowing any unused AMT credit to be refunded in 2018 if the taxpayer elected to accelerate the refund.

2020 Modification to EBL Limitation[51]

The EBL limitation of $250,000 (single) and $500,000 (MFJ) is **eliminated** for tax years 2018–2020. In addition, the excess farm loss limitation does not apply for tax years beginning after 2017 and before 2026.

Note. The elimination of an EBL for tax years 2018–2020 means that a taxpayer may deduct business losses **without limit** for 2018–2020 and carry the losses back **five years**.

The CARES Act provision specifies that EBLs do not include any NOL deduction under §172 or qualified business income deduction (QBID) under IRC §199A, or any deductions related to performing services as an employee. In addition, capital loss deductions are not taken into account in computing the IRC §461(l) EBL limitation, and the amount of capital gain taken into account in calculating the §461(l) limitation cannot exceed the lesser of capital gain net income from a trade or business, or capital gain net income.[52]

Note. Effective for tax years beginning after 2020, business income cannot be offset by wage income, including wages paid from the business.[53] This could result in enhanced audit activity concerning reasonable compensation in the S corporation context.

BUSINESS INTEREST[54]

Note. Businesses entitled to use cash accounting (i.e., those with average revenue for the prior three years not exceeding $26 million for 2020) are not subject to the limitation on deducting business interest.[55]

The CARES Act allows a business with average gross receipts over $26 million (for 2020)[56] to elect to increase the limitation on the deduction of interest from 30% of adjusted taxable income (ATI) to 50% of ATI **for tax years beginning in 2019 and 2020.** A business may elect to use 2019 ATI in calculating the 2020 limitation. If an election is made to compute the limitation using 2019 ATI for a tax year that is a short tax year, the ATI for the taxpayer's last tax year beginning in 2019 that is substituted under the election is equal to the amount that bears the same ratio to the ATI as the number of months in the short tax year bears to 12. A taxpayer may elect out of the increase in the ATI percentage for any tax year beginning in 2019 or 2020. It is an irrevocable election unless the IRS consents to a revocation.

51. CARES Act §2304; IRC §461(l)(1).

52. CARES Act §2304, effective for tax years beginning after 2017.

53. CARES Act §2304.

54. Material in this section is adapted from *Income Tax-Related Provisions of Emergency Relief Legislation.* McEowen, Roger. Apr. 10, 2020. Law Professor Blogs Network. [lawprofessors.typepad.com/agriculturallaw/2020/04/income-tax-related-provisions-of-emergency-relief-legislation.html] Accessed on Jul. 8, 2020. Used with permission from the Law Professor Blog Network; CARES Act §2306.

55. IRC §163(j)(5) defines the term "business interest" as any interest expense properly allocable to a trade or business. "Trade or business" for this purpose does not include an "electing farming business."

56. Rev. Proc. 2019-44, 2019-47 IRB 1093.

In Rev. Proc. 2020-22,[57] the IRS set forth the rules for making a late election or withdrawing an election for real property trades or businesses and farming businesses. The IRS, in the revenue procedure, also provided guidance concerning the following.

- The time and manner for electing out of the 50% ATI limitation for tax years beginning in 2019 and 2020
- Using the taxpayer's ATI for the last tax year beginning in 2019 to calculate the taxpayer's limitation for tax year 2020
- Electing out of deducting 50% of excess business interest expense for tax years beginning in 2020 without limitation

Note. A farming business that previously elected **not** to have the interest limitation apply can either make a late election or elect out of the election that was previously made. This provides flexibility and may allow the use of bonus depreciation on assets with a 10-year or longer life depreciated under the modified accelerated cost recovery system (MACRS).

The 50% ATI limitation does not apply to partnerships for tax years beginning in 2019. Rather, a partner treats 50% of the partner's allocable share of the partnership's excess business interest expense for 2019 as an interest deduction in the partner's first tax year beginning in 2020 without limitation. The remaining 50% of excess business interest from 2019 is subject to the ATI limitation as it is carried forward at the partner level. A partner may elect out of the 50% limitation.[58]

Note. For more information about the modification of the limitation on business interest, see the 2020 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Developments.

INVENTORY ACCOUNTING ISSUES FOR AGRICULTURE

UNIFORM CAPITALIZATION RULES

Pre-TCJA

The uniform capitalization (UNICAP) rules of IRC §263A apply to plants that are used in a farming business. Consequently, taxpayers who have a long-term crop with more than a 2-year preproductive period are not permitted to deduct the costs associated with that crop during the preproductive period.[59] This impacts farmers with vineyards, orchards and other long-lived plants. The costs associated with planting these crops must be capitalized until the crop reaches "commercial production" (usually 3–5 years).

Note. Preproductive costs include direct costs and all indirect costs associated with planting the crop, such as depreciation on the equipment used during this period. Specifically included are the costs of raising plants after they are planted and before they are placed in service (i.e., when they reach commercial production) including costs associated with management, irrigation, fertilizing, depreciation, and repairs on buildings and equipment.

57. Rev. Proc. 2020-22, 2020-18 IRB 745.

58. CARES Act, §2306, effective for tax years beginning after 2018.

59. IRC§§ 263A(a)(1) and (d)(1)(A)(ii). Interest associated with financed land on which the crop is grown also must be capitalized, as must real property taxes. *Wasco Real Properties I, LLC, et al. v. Comm'r,* TC Memo 2016-224 (Dec. 13, 2016).

The rule primarily impacts farmers in the nursery business and almost all tree, vine, or bush crops that require at least two years to reach production.[60] For plants, the preproductive period begins when the seed is planted or the plant is first acquired by the taxpayer. The preproductive period ends when the plant is ready to be produced in marketable quantities or when the plant can reasonably be expected to be sold or otherwise disposed of. The preproductive period, however, is determined not in light of the taxpayer's personal experience but in light of the weighted average preproductive period determined on a nationwide basis.[61] The IRS has provided a list of plants grown in commercial quantities in the United States that have a nationwide weighted average preproductive period in excess of two years.[62]

Note. IRS Notice 2013-18 contained the following noninclusive list of plants with a preproductive period of more than two years: almonds, apples, apricots, avocados, blueberries, cherries, chestnuts, coffee beans, currants, dates, figs, grapefruit, grapes, guavas, kiwifruit, kumquats, lemons, limes, macadamia nuts, mangoes, nectarines, olives, oranges, peaches, pears, pecans, persimmons, pistachio nuts, plums, pomegranates, prunes, tangelos, tangerines, tangors, and walnuts.

Once the plants reach commercial production, their costs can be depreciated over 10 years.[63] As 10-year MACRS property, they are also eligible for either IRC §179 or bonus depreciation.[64]

Under pre-2018 rules, farmers that were not required to use accrual accounting (i.e., corporations, partnerships, or tax shelters) could elect out of UNICAP and deduct the preproductive costs in the year incurred.[65] However, once the election was made, the plants were treated as IRC §1245 property and other farm assets (e.g., farm equipment) were subjected to the alternative depreciation system (ADS), (which means an asset is depreciated over a longer timeframe) when placed in service in a tax year during which the election out of the UNICAP rules was in effect. The election out of UNICAP also meant that such property was **not** eligible for first-year bonus depreciation.[66]

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60. In TAM 9818006 (Jan. 6, 1998), a nursery was entitled to deduct the cost of purchasing "bare root" trees as an ordinary and necessary business expense where the trees were all very young. Many trees did not survive and all required years of development and cultivation to ensure future marketability. In essence, the trees qualified as "seeds and young plants" under Treas. Reg. §1.162-12. When some grow-out is contemplated, nursery operators may use the "farming" exception. IRS Ann. 97-120, 1997-50 IRB 61. Also, the IRS stated that costs incurred between the harvest of a grape crop and the end of the preproductive period must be capitalized unless they are "field costs" (i.e., irrigation, fertilization, spraying, and pruning) that provide no benefit to the already severed crop. ILM 200713023 (Nov. 20, 2006).

61. *Pelaez and Sons, Inc. v. Comm'r,* 2000-1 USTC (CCH) ¶50,395 (11th Cir. 2001), *aff'g* 114 TC No. 28 (2000) (taxpayer failed to establish that preproductive period based on "nationwide weighted average" was two years or less; corporation not able to use own experience to capitalize expenses of citrus trees even though lacking IRS guidance).

62. McEowen, Roger. *Principles of Agricultural Law,* Chapter 6, Sec. 6.05[16], current through Release 46, Jan. 2020 ed.; IRS Notice 2000-45, 2000-36 IRB 256; Treas. Reg. §1.263A-4(b)(2)(i)(B). In 2013, the IRS removed blackberries, raspberries and papayas from the list. Rev. Proc. 2013-20, 2013-14 IRB. For the current list of plants with a preproductive period of more than two years see Table 6-1 of IRS Pub. 225, *Farmers Tax Guide* (2019).

63. Trees and vines are limited to straight-line depreciation.

64. Rev. Proc. 87-56, 1987-2 CB 674; Rev. Proc. 2019-8, 2019-03 IRB 347.

65. There is also an exception to the UNICAP rules for costs related to citrus or almond groves that are in the first four years of maturation after planting.

66. IRC §168(k).

Starting with plantings in 2016, farmers could elect to take 50% bonus depreciation on the cost of "specified plants," **regardless of whether the taxpayer elected out of the UNICAP rules.**[67] This provision provided for an election that allows first-year bonus depreciation for certain plants equal to 50% of their cost (for 2016) that are planted or grafted after 2015. The bonus amount for plants (just like the normal bonus rule), was set to drop to 40% for 2018 and 30% for 2019, and zero thereafter. Under the provision, a **specified plant** is any tree or vine that bears fruit or nuts, and any other plant that will have more than a single yield of fruits or nuts and that generally has a preproductive period of more than two years from the time of planting or grafting to the time at which the plant begins bearing fruits or nuts.[68]

Observation. The definition of specified plant leaves some uncertainty. Does it include the plant plus all §263A preproductive costs incurred for the year of planting? If it does, then the amount that is available for bonus depreciation in the year of planting includes those costs. On the other hand, if that definition only includes the cost of the plant, then preproductive costs that are associated with developing the plant might not be included.[69]

Note. The IRS has not provided guidance detailing whether eligible costs were simply the cost of the plant or whether such costs included all direct and indirect costs in the year of planting.[70]

Example 5. Gary planted a vineyard, including a trellis and irrigation system, in April 2016. The cost of the plants was $100,000. He also incurred $175,000 of preproductive costs during the year. The plants' first marketable crop was in 2019, after he incurred additional preproductive costs of $400,000 in 2017–2019.[71]

Based on the facts of the example, there are a couple of potential outcomes.

Outcome A. If the assumption is made that preproductive costs are included as part of the "specified plant" and that Gary makes the election to take 50% bonus depreciation on $275,000 of plants purchased in 2016 (including capitalized preproductive costs) on the 2016 tax return, what is the result?

The $137,500 ($275,000 × 50%) deduction is not added to his capitalized preproductive costs. He reduces the capitalized costs by this amount.

Assume Gary, in 2019, places in service total capitalized costs of $537,500 ($100,000 + $175,000 – $137,500 + $400,000). During that year, bonus depreciation is not allowed because he may claim bonus depreciation only once on the specified plant.

The trellis and irrigation system are separate assets and bonus depreciation is available for the year the assets are placed in service, if it occurs before 2020. If Gary did not make the election to take bonus depreciation, he would have no deduction in 2016 (giving up a $137,500 deduction) and in 2019, he would place in service $675,000 of assets ($100,000 + $175,000 + $400,000) that would be eligible for 30% bonus depreciation of $202,500.

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67. Ibid.

68. IRC §168(k)(5).

69. Adapted from *Claiming "Bonus" Depreciation on Plants.* McEowen, Roger. Aug. 25, 2016. Law Professor Blogs Network. [lawprofessors.typepad.com/agriculturallaw/2016/08/claiming-bonus-depreciation-on-plants.html] Accessed on Jul. 8, 2020. Used with permission from the Law Professor Blog Network.

70. IRC §168(k)(5)(B) specifies that it is a tree or vine that produces fruit or nuts, or any other plant that bears fruit or nuts.

71. Adapted from *Claiming "Bonus" Depreciation on Plants.* McEowen, Roger. Aug. 25, 2016. Law Professor Blogs Network. [lawprofessors.typepad.com/agriculturallaw/2016/08/claiming-bonus-depreciation-on-plants.html] Accessed on Jul. 8, 2020. Used with permission from the Law Professor Blog Network.

By making the election, Gary claims $137,500 of bonus depreciation in 2016 and normal depreciation on the balance, beginning in 2019. If he had not made the election, he would have a deduction of $202,500 for bonus depreciation in 2019 and normal depreciation on the balance, beginning in 2019. However, if the first marketable harvest was not until 2020, then not making the election would prevent Gary from deducting any bonus depreciation, although the §179 deduction would still be available.

Outcome B. Assume that preproductive costs are not included as part of a "specified plant." In addition, assume that Gary makes the election to take 50% bonus depreciation on $100,000 of plants purchased in 2016 (this does not include capitalized preproductive costs) on the 2016 tax return.

The $50,000 bonus depreciation deduction is not added to his capitalized preproductive costs. He reduces the capitalized costs by this amount.

In 2019, he places in service total capitalized costs of $625,000 ($100,000 – $50,000 + $175,000 + $400,000). During that year, bonus depreciation is not allowed on $50,000 of specified plant costs, but is allowed on the remaining $575,000 of capitalized preproductive costs, because Gary may claim bonus depreciation only once on the specified plant.

Note. With Outcome B, bonus depreciation is claimed (at least in part) twice — once in the year of planting and then on the capitalized costs in the year placed in service. This may be too much of a stretch for the IRS in terms of interpreting the Code provision at issue and may not be the ultimate result (assuming that the IRS does issue some guidance on the matter).

If Gary did not make the election, he would have no deduction in 2016, giving up a $50,000 deduction. In 2019, he would place in service $675,000 of assets ($100,000 + $175,000 + $400,000) that would be eligible for 30% bonus depreciation of $202,500. However, if the first marketable harvest was not until 2020, then not making the election would prevent Gary from deducting any bonus depreciation, although the §179 deduction would still be available.

Practitioner Planning Tip

Timing and planning projections are key to determining the proper position to take on the tax return when starting a vineyard (or other type of business involving specified plants). In addition, taxpayers do not know exactly how to evaluate their options until the IRS clarifies the extent of the costs that are included as part of the "specified plant."

TCJA Period

Under the TCJA, 100% bonus depreciation is available through 2022.[72] In addition, farmers with gross receipts under $25 million ($26 million for 2020) can expense all the direct and indirect costs associated with plantings, including the costs of the plants, because of the ability to use 100% bonus depreciation.[73]

> **Note.** For those farmers who made the election (under prior law) to expense direct and indirect costs of production but who did not have bonus depreciation available, it was not known whether an election could be made under the rules in effect for tax years beginning after 2017 to claim bonus depreciation. If such an election could be made and the taxpayer's gross revenue is less than the applicable threshold, all costs can be deducted currently under the 100% bonus provision. If an election cannot be made, costs must be expensed but bonus depreciation is not available on all farm assets. This is the case even if the taxpayer had not planted any orchards or vineyards for several years.

Example 6. Raymond and Verda, a farm couple, planted an orchard in 2012. Their gross receipts are low enough to allow them to use cash accounting. They elected to expense all costs of the orchard. That election had the effect of barring them from claiming bonus depreciation on **any** farm assets.

In 2018, they bought $1.5 million of farm equipment. If they cannot elect back into bonus depreciation, they cannot claim any bonus depreciation on the farm equipment and can only expense the amounts under §179. If they can elect back into bonus depreciation, the entire $1.5 million of farm equipment purchased in 2018 qualifies for bonus depreciation.

While the TCJA did not address the issue of what costs are included in "specified plants," the TCJA, effective for tax years beginning after 2017, expanded the exception from the UNICAP rules for small businesses, defined as those businesses eligible to use cash accounting under the TCJA rules.[74] Therefore, many farming operations with a crop having more than a 2-year preproductive period are excluded from the UNICAP rules and can currently expense or depreciate their preproductive costs.

> **Note.** IRC §263A(i)(3), effective for tax years beginning after 2017, provides that "[a]ny change in method of accounting made pursuant to this subsection shall be treated for purposes of section 481 as initiated by the taxpayer and made with the consent of the Secretary."

2020 IRS Guidance

Unfortunately, farmers who previously elected out of UNICAP were not provided a method to revoke the election and utilize the TCJA provision eliminating the UNICAP rule for a qualified small business. The prior election out of UNICAP allowed the expensing of preproductive costs, but it also required the use of ADS, which depreciates assets over a longer period of time using the straight-line method (SL) on all farm assets. The use of ADS also eliminated the ability to claim bonus depreciation. Expensing under §179 remained available. The only option available for such farmers was to obtain IRS approval via a private letter ruling.

In February 2020, the IRS addressed the matter with the issuance of Rev. Proc. 2020-13.[75] The guidance allows a farming business who had elected out of UNICAP before 2018 to revoke the election if it qualifies as a small business and elect into the new rule so that bonus depreciation can be utilized for tax years beginning after 2018.

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72. IRC §168(k)(6).

73. IRC §§168(k)(5) and 263A; Rev. Proc. 2019-44, 2019-47 IRB 1093.

74. IRC §263A(i)(1).

75. Rev. Proc. 2020-13, 2020-11 IRB 515.

Example 7. Use the same facts as **Example 6.** In 2020, Raymond and Verda can revoke their election to expense all of the orchard costs. This allows them to use bonus depreciation on the $1.5 million in farm equipment purchased in 2018.

Practitioner Planning Tip

Raymond and Verda's decision to revoke their election and claim bonus depreciation creates an NOL that they can carry back five years.

Section 5 of Rev. Proc. 2020-13 provides the exclusive procedures for a farmer who elected out of UNICAP but now wants to revoke that election. The procedure applies to a farm taxpayer that qualifies as a small business taxpayer within the meaning of §263A(i) who seeks to revoke an election under §263A(d)(3) and who wants to apply the exemption from the UNICAP rules in §263A beginning with the same tax year.

Under Rev. Proc. 2020-13, an eligible small business taxpayer can revoke its §263A(d)(3) election by either:

- Continuing not to capitalize costs of plants produced in its farming business under §263A,[76]
- Changing depreciation of the subject property to the general depreciation system (GDS) beginning with the year of revocation,[77] or
- Continuing to treat plants that are or have been treated as §1245 property for prior tax years as §1245 property.[78]

For an eligible small business taxpayer that timely filed its federal income tax return for its tax year beginning in 2018 that wants to revoke its §263A(d)(3) election for the 2018 tax year and did not revoke the election within the time and manner noted in Rev. Proc. 2020-13, the taxpayer may file an amended return for the 2018 tax year before the taxpayer files its federal income tax return for the first tax year beginning after the 2018 tax year.[79] Alternatively, the taxpayer may file Form 3115, *Application for Change in Accounting Method,* with a timely filed federal income tax return for the first, second, or third tax year beginning after the 2018 tax year.[80]

Note. The late revocation of the §263A(d)(3) election will only be treated as a change in accounting method with an IRC §481(a) adjustment during the three tax years beginning after the 2018 tax years.[81]

76. Rev. Proc. 2020-13, 2020-11 IRB 515, §5.02(1)(a).

77. Ibid, §5.03. This approach is applicable to existing and newly acquired property, except that bonus depreciation is disallowed for existing property. See IRC §168(k)-1(f)(6)(iv)(B) and Treas. Reg. §1.168(k)-2(g)(6)(iv)(B).

78. Rev. Proc. 2020-13, 2020-11 IRB 515, §5.02(1)(c).

79. Rev. Proc. 2020-13, 2020-11 IRB 515, §5.02(2)(a). For a partnership that is subject to the centralized partnership audit regime enacted as part of the Bipartisan Budget Act of 2015, an administrative adjustment request (AAR) for the 2018 tax year is to be filed before the return for the first tax year after 2018 is filed.

80. Rev. Prov. 2020-13, 2020-11 IRB 515, §5.02(2)(b).

81. Rev. Proc. 2020-13, 2020-11 IRB 515, §5.02(2)(b). Rev. Proc. 2019-43 has been modified to provide automatic consent for a late revocation of the election during the specified time period. The designated automatic accounting method change number for a change to the method of accounting under this section is "243." Rev. Proc. 2020-13, 2020-11 IRB 515, §§7.01-.02.

For those farmers that elected out of UNICAP under §263A(i) and now have gross receipts that disqualify them from meeting the definition of an eligible small business taxpayer and who now desire to elect out of the UNICAP rules under §263A(d)(3), the election out is to be made on the return for the first tax year for which the §263A(i) provision is not available.[82]

> **Note.** A taxpayer who follows Rev. Proc. 2020-13 for the first tax year the former small business taxpayer no longer qualifies to use the exemption under §263A(i) is **not** treated as making an accounting method change under IRC §446(e).[83]

Transition Rule. If a taxpayer has already filed Form 3115 seeking IRS permission to revoke its election out of UNICAP, the taxpayer must request a private letter ruling advising the national office of the IRS that the taxpayer is utilizing the revocation procedures of Rev. Proc. 2020-13. According to the revenue procedure, the national office will acknowledge the request via letter and return the submitted user fee.[84]

DEDUCTIBLE REPAIRS, CAPITALIZED IMPROVEMENTS, AND THE DE MINIMIS SAFE HARBOR

In the fall of 2013, the IRS issued final regulations providing guidance on the application of IRC §§162(a) and 263(a) to amounts paid to acquire, produce, or improve tangible property.[85] The final regulations are generally effective for tax years beginning on or after January 1, 2014.[86] At the same time, proposed regulations providing guidance on the application of general asset account and disposition rules under §168 were issued.[87] Final regulations on dispositions were issued in August 2014.[88]

> **Note.** The line between where deductible repairs under §162(a) ends and improvements required to be capitalized under §263(a) begins has always been far from clear and has led to much controversy between taxpayers and the IRS. The final regulations generally apply facts-and-circumstances-based rules rather than bright-line quantitative tests. Thus, the precise location of the line to differentiate the two is still often unknown, but substantive changes have been made in making this determination.

De Minimis Safe Harbor Election

Amounts paid to acquire or produce tangible property, not exceeding a certain dollar threshold, may be deducted under the de minimis safe harbor. To be eligible, however, a taxpayer must meet the following tests.

- Have an applicable financial statement (AFS)
- Have at the beginning of the tax year **written** accounting procedures treating as an expense for nontax purposes amounts paid for property costing less than a specified dollar amount, or amounts paid for property with an economic useful life of 12 months or less
- Treat the amounts paid during the tax year as an expense on its AFS in accordance with its written accounting procedures
- Treat the amounts that do not exceed $5,000 per invoice or per item as not capitalized[89] (The additional costs associated with the property (delivery fees, installation services, etc.) must be included in the per item cost if included on the same invoice.[90])

82. Rev. Proc. 2020-13, 2020-11 IRB 515, §6.01. The election is to be made in accordance with Treas. Reg. §1.263A-4(d)(3) and no longer capitalizing the costs of plants produced in the taxpayer's farming business. Rev. Proc. 2020-13, 2020-11 IRB 515, §6.02.

83. Rev. Proc. 2020-13, 2020-11 IRB 515, §6.01.

84. Ibid, §8.02.

85. TD 9636, 2013-43 IRB 331.

86. Taxpayers did have the option to adopt the regulations for tax years beginning on or after January 1, 2012.

87. REG-110732-13.

88. TD 9689, 2014-36 IRB 456.

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

90. Treas. Reg. §1.263(a)-1(f)(3)(i).

An AFS is defined as:

1. A financial statement filed with the Securities and Exchange Commission (the 10-K or the Annual Statement to Shareholders);
2. A certified audited financial statement prepared by an independent CPA that is used for credit purposes, reporting to equity holders, or any other substantial nontax purpose; or,
3. A financial statement required to be provided to the federal or a state government or any federal or state agency.[91]

Most farm businesses do not have an AFS. However, taxpayers without an AFS can also utilize the de minimis safe harbor by satisfying the same requirements listed above except that the maximum amount paid for the property is $2,500 per invoice or item instead of $5,000.[92]

For taxpayers without an AFS who are using the $2,500 limit, the accounting policy to expense such items need not be in writing. A taxpayer with both an AFS and a nonqualifying financial statement must meet the requirements for taxpayers with an AFS in order to utilize the safe harbor.

The de minimis safe harbor is not intended to prevent a taxpayer from reaching an agreement with the IRS examining agents that, as an administrative matter based on risk analysis or materiality, the IRS examining agents will not review certain items.[93]

Note. The safe harbor is not intended to be a threshold of materiality. The taxpayer has the burden of showing that deducting amounts in excess of the threshold does not distort income.

In IRS guidance posted on its website in March 2015,[94] the IRS clarified that if a business has a policy for its books and records of deducting amounts costing more than the de minimis safe harbor amount, it can properly deduct those amounts for federal tax purposes, providing that the taxpayer can show that the policy clearly reflects its income.

This IRS guidance also suggested that the taxpayer should still elect the de minimis safe harbor for items costing at or below the de minimis threshold amount "to assure that the deduction of the items costing $2,500… or less will not be questioned by the IRS."[95]

Note. The safe harbor allows many small taxpayers the flexibility to fully expense many asset purchases without utilizing any of the taxpayer's §179 limit. This can free-up the §179 deduction for more expensive items. Use of the safe harbor method reduces the amount of items added to the depreciation schedule. In addition, it reduces the amount of qualifying property that may affect the QBID.

91. Treas. Reg. §1.263(a)-1(f)(4).
92. Treas. Reg. §1.263(a)-1(f)(1)(ii); IRS Notice 2015-82, 2015-50 IRB 859.
93. Preamble to TD 9636, 2013-43 IRB 331.
94. *Tangible Property Regulations — Frequently Asked Questions.* IRS. [www.irs.gov/businesses/small-businesses-self-employed/tangible-property-final-regulations] Accessed on Jul. 13, 2020.
95. Ibid.

A taxpayer makes the de minimis safe harbor election **annually** by attaching a statement to its timely filed federal tax return. The election must be applied to all amounts paid during the year for property meeting the requirements discussed above.[96] The de minimis safe harbor is elected by attaching a statement titled "Section 1.263(a)-1(f) de minimis safe harbor election" to the timely filed original federal tax return, including extensions, for the tax year in which the de minimis amounts are paid. The statement should include the taxpayer's name, address, and taxpayer identification number, as well as a statement that the taxpayer is making the de minimis safe harbor election.[97]

Note. The de minimis safe harbor is an annual election, not a change in method of accounting. No Form 3115 is required to elect the de minimis safe harbor, nor is a Form 3115 required to stop applying the de minimis safe harbor for a subsequent year.[98]

The de minimis rule characterizes all income from the sale of expensed items as ordinary income. The regulations hold that property to which a taxpayer applies the de minimis safe harbor is not treated as a capital asset under IRC §1221 nor as property used in a trade or business under IRC §1231.[99] This rule can increase the tax upon the sale of items that appreciate in value (e.g., breeding and dairy animals) that may be taxed under the rules for long-term capital gains. If those items were depreciated and/or expensed using §179, only §179 and depreciation is recaptured as ordinary income. These sales should be reported on Form 4797.

The regulations specifically prohibit the use of the de minimis safe harbor for property held as inventory for resale.[100]

Note. There is no authority for selecting a different de minimis safe harbor amount for different classes or categories of assets within the same tax year. Accordingly, taxpayers who purchase breeding stock with a per-unit cost less than their de minimis safe harbor election will face ordinary income upon disposition of those animals.

Example 8. Porky Pigs often buys gilts as replacement breeding stock for its hog-producing operation. During 2020, Porky buys 400 gilts at $250 each, for a total of $100,000. If Porky makes a de minimis safe harbor election for the current year, he may expense the $100,000 expenditure because each item is under the $2,500 threshold. Thus, Porky does not use any of his §179 limit for 2020 for the purchase of the breeding hogs. In addition, **the sale of the cull sows results in ordinary income reporting that is not subject to SE tax.**

The de minimis safe harbor is an administrative convenience that allows a taxpayer to deduct small dollar expenditures for the acquisition or production of property that otherwise must be capitalized under general rules. Amounts deducted under the de minimis rule are not capitalized nor are they treated as materials or supplies.[101] All tangible property is eligible for the de minimis safe harbor except land and property that is or is intended to be included in inventory.[102]

Note. A taxpayer making the de minimis safe harbor election is not required to capitalize all amounts in excess of the $5,000/$2,500 threshold. The de minimis safe harbor election simply eliminates the burden of determining whether every small dollar expenditure must be deducted or capitalized.

96. Treas. Reg. §1.263(a)-1(f)(5). There is an exception for certain rotable, temporary, or standby emergency spare parts. Treas. Reg. §1.162-3(d).

97. Treas. Reg. §1.263(a)-1(f)(5).

98. In the case of a consolidated group filing a consolidated income tax return, the election is made for each member of the consolidated group by the common parent. Treas. Reg. §1.263-1(f)(5).

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

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

101. Treas. Reg. §1.263(a)-1(f)(1).

102. Treas. Reg. §1.263(a)-1(f)(2).

TAX TREATMENT OF MEALS AND ENTERTAINMENT[103]

Many farming and ranching operations provide meals for employees and receive a tax break for doing so. However, the TCJA modified the rules. In 2018, the IRS provided guidance on the changed rules and how to distinguish between deductible meals and nondeductible entertainment expenses under the TCJA. That guidance was issued as a precursor to formal regulations on the issue. In early 2020, the Treasury Department issued proposed regulations addressing the TCJA changes.[104]

MEALS

For farming and ranching operations, the tax rules governing meals often are taken into account seasonally. An example is part-time workers who are employed at times of planting and harvest. These part-time employees may be fed lunches on the farm. Before 2018, meals were normally deductible to an employer at 50% of the cost of the meals. However, when the meals are provided on the employer's premises (i.e., at the farm) and for the convenience of the employer, the meals are 100% deductible by the employer and the employees do not have to report any of the cost of the meals as income.[105]

> **Note.** The 100% deduction is because farm workers generally work in remote areas where eating facilities are not conveniently located, and the farm employer finds it a more productive use of time to supply meals at the farm.

Under the TCJA, the 50% rule still generally applies to allow an employer to deduct 50% of the reasonable food and beverage expenses associated with operating the business (e.g., meals consumed by employees on work travel).[106] However, for amounts incurred and paid after December 31, 2017, and until December 31, 2025, the TCJA expands the 50% limitation to expenses of the employer associated with providing food and beverages to employees through an eating facility that meets requirements for de minimis fringes and for the convenience of the employer.[107] Consequently, the former 100% deduction for meals provided to part-time farm employees is now reduced to 50%. The 50% limitation remains in place through 2025 for meals (food and beverages) that are not "lavish or extravagant" and the taxpayer or employee of the taxpayer is present when the meal is furnished.[108] Of course, the 50% reduction can be avoided by treating the food and beverages as compensation to the employee (i.e., wages for withholding purposes). After 2025, none of the cost of meals is deductible.[109]

> **Note.** Some meals remain 100% deductible under specific exceptions contained in §274(e), such as those incurred at a company Christmas party, annual picnic, or summer outings so long as there is no discrimination in favor of highly compensated employees.[110] It is unclear whether different rules apply if the event is for a company division or subsidiary rather than the entire company. It is also unclear whether charitable donations can be disallowed as entertainment deductions.

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103. Adapted from *Tax Treatment of Meals and Entertainment.* McEowen, Roger. Mar. 9, 2020. Law Professor Blogs Network. [lawprofessors.typepad.com/agriculturallaw/2020/03/tax-treatment-of-meals-and-entertainment.html] Accessed on Jul. 8, 2020. Used with permission from the Law Professor Blog Network.

104. Prop. Treas. Reg. §1.274-11.

105. IRC §119.

106. IRC §274(k).

107. IRC §274(n)(1).

108. IRC §274(k)(1).

109. IRC §274(o).

110. See also IRC §274(e)(4).

ENTERTAINMENT

Through 2017, deductions for entertainment were generally disallowed unless they were directly related to the taxpayer's business or directly preceded or followed a substantial bona fide business discussion. In those instances, 50% of entertainment expenses were deductible. Under the TCJA, effective for tax years after 2017, no deduction is allowed for any activity that is generally considered entertainment, amusement, or recreation that is purchased as a business expense. In addition, no deduction is allowed for membership dues for any club organized for business, pleasure, recreation, or other social purposes. Similarly, no deduction is allowed that is associated with a facility or portion thereof used in connection with the provision of entertainment, amusement or recreation.[111]

Before 2018, 50% of the cost of business meals and entertainment purchased for business purposes was deductible. Currently, entertainment expenses are not deductible even if they are incurred in a business context, unless they can satisfy an exception contained in IRC §274(e). This creates an issue of how to distinguish between deductible meals and nondeductible entertainment when they are provided together (discussed next).

IRS GUIDANCE

In 2018, the IRS issued Notice 2018-76,[112] to assist taxpayers to distinguish between deductible meals and nondeductible entertainment. The guidance in the notice can be relied on until final regulations are issued.

The notice clarifies that taxpayers may deduct 50% of a business meal expense that meets all of the following requirements.

1. The expense must be an ordinary and necessary business expense as defined by §162(a).
2. The expense must not be "lavish or extravagant" based on the particular situation.
3. The taxpayer, or an employee of the taxpayer, must be present when the food or beverages are furnished.
4. The meal must be provided to a current or potential business customer, client, consultant, or similar business contact.
5. If the meal is provided in conjunction with entertainment, the meal expenses must be **stated separately** from the entertainment expenses.

> **Note.** Based on the notice, it is clear that meals expenses should not be inflated to make up for the loss of entertainment-related deductions. Separately purchasing meals and entertainment is important. The deduction for meals can be lost if the meals and entertainment are purchased together unless the "stated separately" requirement is satisfied.

111. Prop. Treas. Reg. §1.274-11.

112. IRS Notice 2018-76, 2018-42 IRB 599.

PROPOSED REGULATIONS[113]

On February 21, 2020, the IRS issued proposed regulations on the deductible meal/nondeductible entertainment issue. The proposed regulations generally follow IRS Notice 2018-76 (listed previously), which can be relied upon until the regulations are finalized. Under the proposed regulations, taxpayers may deduct 50% of an otherwise allowable business meal expense if they meet the same five requirements listed in IRS Notice 2018-76.

"Food or beverage" expense is defined as "…all food and beverage items, regardless of whether characterized as meals, snacks, or other types of food and beverages, and regardless of whether the food and beverages are treated as de minimis fringes under section 132(e)."[114] When food and beverages are provided to a potential business contact, the food and beverages must be provided to a "person with whom the taxpayer could reasonably expect to engage or deal in the active conduct of the taxpayer's trade or business such as the taxpayer's customer, client, supplier, employee, agent, partner, or professional adviser, whether established or prospective."[115] The proposed regulations also apply this standard to employer-provided meals and when meals are provided to employees and nonemployee business associates at the same event.

> **Note.** Whether a spouse who accompanies an employee at a business event can also be provided meals for which the employer receives a 50% deduction is not clear. The issue is whether the spouse is present for a business purpose.

To provide a means for the IRS to determine that food and beverage costs have not been inflated, the proposed regulations require that the venue's typical selling cost for the food and beverages items sold must be listed if they were purchased apart from any entertainment.[116] If the typical selling price is not listed, the reasonable approximate value must be provided. However, the proposed regulations also state that if a single invoice is used for food and beverage costs and entertainment, the amount for food and beverages must be billed separately to be eligible for any deduction.[117]

Nondeductible "entertainment" under the proposed regulation is "any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at bars, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or the taxpayer's family."[118] It does not matter that expenses for such activities are associated with the taxpayer's trade or business — it is still considered entertainment. "Entertainment" can also include activities that are engaged in to satisfy personal living needs of the taxpayer and the taxpayer's family.

> **Note.** As an example, the expenses associated with a fishing trip on Lake Michigan to provide salmon for the family for the next year could constitute nondeductible entertainment expenses. Similarly, the cost of a trip into the Teton Wilderness Area with clients and potential clients could also be fully nondeductible.

The proposed regulations apply to tax years beginning on or after the date they are published in the Federal Register as final regulations. Before that time, however, they can be relied on for expenses incurred after 2017. In addition, taxpayers can continue to rely on IRS Notice 2018-76 until the proposed regulations are finalized.

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113. REG-100814-19, 85 FR 11020.
114. Prop. Treas. Reg. §1.274-12(b)(1).
115. Prop. Treas. Reg. §1.274-12(b)(3).
116. Prop. Treas. Reg. §1.274-11(b)(1)(ii).
117. Ibid.
118. Prop. Treas. Reg. §1.274-11(b)(1)(i).

SOLAR ENERGY TAX ISSUES

A solar "farm" can take several forms. Typically, a solar farm consists of solar panels mounted on large racks in a field, pasture, or other parcel. Another common form of solar farm is "thermal" which is based on water heated by the sun. Many of the early generation solar farms used thermal technology as do some of the current large-scale solar farms. A thermal solar farm uses mirrors to concentrate the sun's heat onto a central column that uses the high temperature to create steam. The steam turns a turbine to make electricity. A photovoltaic solar farm uses panels covered with photovoltaic cells to convert the sun's light directly into electricity.

A solar farm can vary widely in size—from a few acres to several hundred or thousands of acres. Many are located in desert areas. Site location is dependent upon the composition of the soil, access to water, and access to power lines and substations. Zoning and contractual issues can also be important factors influencing site location.

Often a solar farm is financed. The USDA and the United States Environmental Protection Agency (EPA) are possible funding sources for solar farms along with private investors. Another possible arrangement that can be included with a financing deal is the lease of land from a user of the solar power that the solar farm generates.

Solar farm installation costs may be eligible for rebates. Tax credits can be utilized to offset the cost of installation and operation. A residential energy credit is available for solar-generated electricity for use in a residence or a commercial building.[119] The Code also provides for a commercial energy credit.[120]

SOLAR ENERGY CREDITS[121]

Residential Energy Credit

A taxpayer may claim a residential energy efficient property credit of 26% for the costs of the solar panels and related equipment and material installed to generate electricity for use by a residential or commercial building.[122] A taxpayer is "allowed as a credit against the tax imposed…for the taxable year, an amount equal to the sum of… the qualified solar electric property expenditures."[123] Such expenditures are "for property which uses solar energy to generate electricity for use in a dwelling unit located in the United States and used as a residence by the taxpayer."[124] The credit is claimed on Form 5695, *Residential Energy Credits,* and computed by taking into account the cost of solar panels as well as piping or wiring to connect the property to the dwelling unit plus labor costs.[125] For a newly constructed home, the taxpayer may request that the homebuilder make a reasonable allocation or the taxpayer may use any other reasonable method to determine the cost of the property that is eligible for the credit.[126]

A taxpayer who claims the credit for solar energy property installed in their principal residence or vacation home must reduce their income tax basis in the property by the amount of the credit.[127]

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119. IRC §25D. The credit is also available for qualified improvements to rental properties, as well as a vacation home that the taxpayer owns. The credit is nonrefundable with any excess carried forward to the next year's return. IRC §25D(c).

120. IRC §48.

121. Adapted from *Solar "Farms" and The Associated Tax Credit.* McEowen, Roger. May 15, 2020. Law Professor Blogs Network. [lawprofessors.typepad.com/agriculturallaw/2020/05/solar-farms-and-the-associated-tax-credit.html] Accessed on Jul. 8, 2020. Used with permission from the Law Professor Blog Network.

122. IRC §25D.

123. IRC §25D(a).

124. IRC §25D(d)(2).

125. IRC §25D(e)(1)-(2). See also Ltr. Rul. 201130003 (Apr. 19, 2011); Ltr. Rul. 201809003 (Nov. 27, 2017).

126. IRS Notice 2013-70, 2013-47 IRB 528, Q&A No. 21.

127. A home includes a house, houseboat, mobile home, cooperative apartment, condominium, and a manufactured home. See Instructions to Form 5695, *Residential Energy Credits.*

For most types of energy property, eligibility for the credit and in some cases the amount of the credit for which the property is eligible, depend on meeting certain deadlines for beginning construction on the energy property and placing the property in service.

Caution. For a taxpayer claiming a residential energy efficient property credit for solar installation, payments may be received by the homeowner for excess electricity generated and sold to the electric utility or other buyers. These payments may be in the form of renewable energy certificates or cash. In either case, the payment is includable in the homeowners' gross income in the year received. The amount is reported on Form 1040, Schedule 1, line 8 as other income.[128]

Commercial (Business) Energy Credit

IRC §48 provides a credit for "energy property placed in service during [the] taxable year."[129] The amount of the credit is a percentage of energy based on each energy property placed in service during the tax year. The energy percentage is 26% for solar energy property that is under construction on or before December 31, 2020, and placed in service before January 1, 2024.[130] The credit belongs to the owner of the solar energy property and is claimed on Form 3468, *Investment Credit,* with the amount of the credit carried to Form 1040. Fifty percent of the credit claimed must be used to reduce the depreciable basis of the energy property.[131]

Example 9. Sunny Ray decides to acquire a solar energy system to reduce utility costs for the farm machine shed and grain bins. The purchase price is $66,000, with the amount paid in full September 15, 2020, and the property is placed in service on September 19, 2020.

Sunny is a calendar-year taxpayer and reports farm income on Schedule F. Sunny is eligible for a $17,160 energy credit ($66,000 × 26%), which is claimed on Form 3468, part III. The depreciable basis of the solar energy system is reduced by 50% of the credit to $57,420 ($66,000 – (50% × $17,160)). Sunny may deduct the $57,420 cost either by selecting a specific amount under §179, or using bonus depreciation for 100% of the cost. The remaining amount, if any, is depreciated under MACRS over five years.

Note. IRS Notice 2018-59 provides taxpayers with two methods to establish the beginning of construction — either by starting physical work of a significant nature (the "physical work" test), or by satisfying a safe harbor (the "5% safe harbor" test). Under the safe harbor, construction is deemed to begin when the taxpayer pays or incurs 5% or more of the total cost of the energy property and thereafter makes **continuous efforts** to advance towards completion of the energy property. While either method may be used, construction is deemed to have begun on the date the taxpayer first satisfies one of the two methods.

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128. Ltr. Rul. 201035003 (May 19, 2010).

129. IRC §48(a)(1).

130. IRS Notice 2018-59, 2018-28 IRB 196.

131. Instructions for Form 3468; IRC §50(c)(3).

Energy property is defined as any "equipment which uses solar energy to generate electricity to…a structure" and "equipment which uses solar energy to illuminate the inside of a structure."[132] The regulations provide additional guidance. Treas. Reg. §1.48-9(d)(1) provides that "'solar energy property' includes equipment and materials (and parts related to the functioning of such equipment) that use solar energy directly to (i) generate electricity, (ii) heat or cool a building or structure, or (iii) provide hot water for use within a building or structure." Treas. Reg. §1.48-9(d)(3) defines electric generation equipment as follows.

> *Solar energy property includes equipment that uses solar energy to generate electricity, and includes storage devices, power conditioning equipment, transfer equipment, and parts related to the functioning of those items. In general, this process involves the transformation of sunlight into electricity through the use of such devices as solar cells or other collectors. However, solar energy property used to generate electricity includes only equipment up to (but not including) the stage that transmits or uses electricity.*

In addition, Treas. Reg. §1.48-9(d)(4) specifies that "[p]ipes and ducts that are used exclusively to carry energy derived from solar energy are solar energy property."

> **Note.** The credit is part of the general business credit under IRC §38. Property that is eligible for the general business credit is tangible property for which depreciation is allowable.[133]

The solar energy credit is part of the investment credit under IRC §46(2), which means that it is subject to the rules that apply to unused general business credits under §38(a). Unused credit amounts are carried back one year and then to each of the 20 years following the unused credit year.[134] The credit is nonrefundable and may only be used against the taxpayer's actual tax liability.[135] The entire amount of the unused credit must be carried back one year before it may be carried forward for up to 20 years.[136]

The solar equipment can be owned by one party and used on another person's property. In that situation, the owner/lessor may claim the energy credit provided that the solar property is placed in service and meets the other requirements of IRC §48.[137]

> **Note.** There appears to be nothing that would disallow the credit if the eligible property is installed on a related entity's property. If the taxpayer documents that the taxpayer is the source of the capital for the solar energy property, and retains an actual and legal proprietary interest in the property together with the risk of loss for the property, the taxpayer should be able to show that the taxpayer retains beneficial and legal ownership of the solar energy property for purposes of the credit.[138]

As noted earlier, the owner of the solar energy property is entitled to the energy credit. If the IRS challenges the ownership issue in lessor/lessee situations, the most important factor in determining ownership is the source of capital for the solar energy property.[139] The party that is exposed to the risk of loss from supplying the necessary capital for the asset and retaining an actual and legal proprietary interest in the asset is the owner of the property that is entitled to the credit.[140]

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132. IRC §48(a)(3).

133. IRC §48(a)(5)(D).

134. IRC §39(a)(1).

135. IRC §38(c)(1).

136. IRC §39(a)(2)(A).

137. Rev. Rul. 79-264, 1979-2 CB 92.

138. But see *Fleming v. Comm'r,* TC Memo 1985-165 (Apr. 2, 1985) (investment credit allowed for certain movable walls through estimates the taxpayer and the IRS offered when the taxpayer had no records of the cost of the partitions).

139. *Carnegie Productions, Inc. v. Comm'r,* 59 TC 642 (1973).

140. Ibid.

A lessor of new solar energy property may elect to pass the credit to the lessee if the transaction involves a profit intent and the lease is a bona fide lease. The property is deemed to be placed in service when it is first held out for leasing to others in a profit-motivated leasing venture.[141] A sale/leaseback is also possible, which allows the lessee to claim the credit or permits the lessor to pass through its credit to a lessee.[142]

Note. If the owner of the solar energy property causes the property to cease being §38 property during the same tax year that it is placed in service, no credit is allowed.[143]

The solar energy credit can also be used to offset AMT liability without limitation.[144]

The following table from IRS Notice 2018-59 summarizes commercial energy credit requirements.

Type of Energy Property	Date Construction Begins	Placed in Service Date	ITC Amount
Solar	Before 1/1/20	Before 1/1/24	30%
	1/1/20 – 12/31/20	Before 1/1/24	26%
	1/1/21 – 12/31/21	Before 1/1/24	22%
	Before 1/1/22	On or after 1/1/24	10%
	On or after 1/1/22	Any	10%
Fiber-Optic Solar	Before 1/1/20	Before 1/1/24	30%
	1/1/20 – 12/31/20	Before 1/1/24	26%
	1/1/21 – 12/31/21	Before 1/1/24	22%
	Before 1/1/22	On or after 1/1/24	0%
	On or after 1/1/22	Not applicable	0%
Geothermal	Any	Any	10%
Qualified Fuel Cell	Before 1/1/20	Before 1/1/24	30%
	1/1/20 – 12/31/20	Before 1/1/24	26%
	1/1/21 – 12/31/21	Before 1/1/24	22%
	Before 1/1/22	On or after 1/1/24	0%
	On or after 1/1/22	Not applicable	0%
Qualified Microturbine	Before 1/1/22	Any	10%
	On or after 1/1/22	Not applicable	0%
CHP	Before 1/1/22	Any	10%
	On or after 1/1/22	Not applicable	0%
Qualified Small Wind	Before 1/1/20	Before 1/1/24	30%
	1/1/20 – 12/31/20	Before 1/1/24	26%
	1/1/21 – 12/31/21	Before 1/1/24	22%
	Before 1/1/22	On or after 1/1/24	0%
	On or after 1/1/22	Not applicable	0%
Geothermal Heat Pump	Before 1/1/22	Any	10%
	After 1/1/22	Not applicable	0%

141. See, e.g., *Cooper et al. v. Comm'r,* 88 TC 84 (1987).

142. Special lessor-lessee rules avoid the basis reduction adjustment when the credit is passed through to a lessee.

143. *Wilmoth v. Comm'r*, TC Memo 1981-206 (Apr. 27, 1981).

144. IRC §38(c)(4)(B)(ix). See also IRC §38(c)(4)(A)(i).

Specific Tax Issues

The Tax Court decided numerous issues associated with solar-powered electricity-generating equipment in *Golan v. Comm'r.*[145] The court addressed income tax basis, eligibility for first-year bonus depreciation, the at-risk rules of IRC §465, and the passive loss rules of IRC §469.

Facts of the Case.[146] In 2010, the petitioners (a married couple), sought an income-producing investment and thought they would do so by purchasing solar equipment from a seller of such equipment. The seller identifies property owners and offers them discounted electricity in exchange for permission to install solar panels and related equipment on their properties (known as "host properties"). The seller remains the owner of the solar equipment and temporarily retains the burdens and benefits of ownership (including all resulting tax credits and rebates). The seller then sells the solar equipment (and the associated rights and obligations) to a buyer (the petitioners).

An owner of a host property filed an application with the local utility company for an interconnection agreement (for net energy metering), and the seller entered into a power purchase agreement (PPA) with the owner of the host property. The seller, as noted, temporarily retained ownership of the solar equipment and was responsible for any servicing or repairs. The PPA barred the owner of the host property from assigning the PPA to another party without the seller's consent, but the seller could assign its interest in the PPA to another party with 30 days' notice to the host. Once the solar panels were installed, the utility company informed the host property owner of eligible rebates, which the host property owner assigned to the seller.

The sale of the solar equipment to the petitioners was accomplished in 2010 under a solar PPA coupled with a promissory note and guarantee that the petitioners signed. It was completed with a bill of sale and conveyance. The solar equipment was installed on the host properties in 2010, but under the purchase agreement, the "original use" of the solar equipment "shall commence on or after the Closing Date." The purchase price was set at $300,000, consisting of a $90,000 down payment due on closing in early 2011; a $57,750 credit for the rebates the seller received from the utility company before the sale; and the petitioners' promissory note in the principal amount of $152,250 with interest at 2%. The solar equipment secured the note and all monthly revenue generated from the solar equipment was to be applied to the note. If accrued interest exceeded monthly receipts for any particular month, the difference was to be carried forward and the petitioners would owe it in future months. If monthly receipts exceeded accrued interest and amortized principal, the excess would accelerate the loan's repayment. Upon default, the seller would seek recourse against the solar equipment before exercising any remedies against the petitioners, and the petitioners were liable to pay any deficiencies owed to the seller if sale of the collateral upon foreclosure did not pay outstanding amounts owed to the seller. The petitioners also signed a guarantee for the note.

Ultimately, the petitioners failed to pay the down payment in 2011 but did make partial payment in 2012 and 2013. In addition, the petitioners instructed the owners of the host properties to make direct payment of electricity bills to the seller, who then credited the payments toward the note. The seller continued to honor the purchase agreement.

On their 2011 return, the petitioners' Schedule C reported no income, but claimed various deductions including depreciation of $255,000.[147] The $255,000 figure was the difference between their claimed $300,000 basis in the solar equipment, and the claimed $90,000 energy credit reduced by one-half in accordance with IRC §§50(c)(1) and (3)(A). On their associated Form 4562, *Depreciation and Amortization,* the petitioners stated that the $255,000 deduction was a "[s]pecial depreciation allowance for qualified property." Also attached to the 2011 return was Form 3468 on which they claimed a $90,000 energy credit (30% of $300,000).

145. *Golan v. Comm'r,* TC Memo 2018-76 (Jun. 5, 2018).

146. Adapted from *Solar "Farms" and The Associated Tax Credit.* McEowen, Roger. May 15, 2020. Law Professor Blogs Network. [lawprofessors.typepad.com/agriculturallaw/2020/05/solar-farms-and-the-associated-tax-credit.html] Accessed on Jul. 8, 2020. Used with permission from the Law Professor Blog Network.

147. The petitioners stated that the Schedule C business was as a "consultant" for the seller's business. The petitioners were also on the cash method of accounting.

The IRS disallowed the depreciation deduction[148] on the basis that the solar equipment did not qualify for "bonus" depreciation because it was neither acquired after September 8, 2010, nor placed in service before January 1, 2012. The IRS also disallowed the energy credit, claiming that the petitioners did not have a basis in the energy property because no funds changed hands. In addition, the IRS asserted that the petitioners were not at-risk with respect to the promissory note and, as a result, could not claim any basis in the note. The IRS's position was based on the sellers' prohibited continuing interest in the solar equipment activity.[149] The IRS also took the position that the passive loss rules applied to the petitioners' Schedule C loss and claimed solar energy credit. An accuracy-related penalty was also applied.

The Tax Court's Holdings. The court held as follows.

1. **Income tax basis.** Because the down payment of $90,000 was not paid in 2011, that amount could not be applied to the petitioners' basis in the solar property for 2011, under Treas. Reg. §1.1012-1(a). As for the $57,750 credit for the rebates assigned to the utility company by the owners of the host properties, the petitioners neither received them nor reported them as income. This amount could also not be applied to the petitioners' basis in the solar equipment because it was not part of the petitioners' cost of the solar equipment. The $152,250 promissory note was a recourse obligation that was issued in exchange for the solar equipment. As such, the face amount of the note could be included in the petitioners' basis in the solar equipment. Accordingly, the petitioners' income tax basis in the solar equipment was $152,250.

2. **Bonus depreciation.** The Tax Court determined that the solar equipment did qualify for bonus depreciation because the petitioners acquired it (as the original user) in January 2011 and placed it in service that year.[150] While the solar property was installed on the host properties in 2010, the IRS failed to prove that the property was connected to the grid before 2011. As such, the solar property was not ready and available for its intended use until it was connected to the electric grid, and that was in 2011 rather than 2010.

3. **At-risk rules.** The Tax Court disagreed with the IRS's claim that the seller had a prohibited continuing interest in the solar equipment activity under IRC §465(b)(3). The IRS failed to identify any provision of the purchase agreement entitling the seller to the solar equipment upon liquidation. Similarly, the seller was not shown to have an interest in the net profits of the petitioners' solar energy venture. The right to have monthly revenue applied to the note was a permitted gross receipts interest.[151] It was immaterial that the seller was also a promoter of the transaction.[152]

4. **Passive loss rules.** The petitioners claimed that the husband participated in the solar energy venture for at least 100 hours in 2011 and that his participation was not less than that of any other individual, thus satisfying the material participation test of Temp. Treas. Reg. §1.469-5T(a)(3). The Tax Court viewed the husband's testimony as credible and the IRS failed to establish otherwise.

5. **Penalty.** The Tax Court did not uphold the accuracy-related penalty, finding that the petitioners made a good faith effort to determine their tax liability and reasonably relied on the advice of their tax preparer.

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148. The IRS notice of deficiency mistakenly referred to the depreciation as IRC §179 depreciation when it should have referred to first-year bonus depreciation under IRC §168(k)(5).

149. See IRC 465(b)(3).

150. In addition, the property had a recovery period of 20 years or less and the original use of the property commenced with the petitioners after 2007.

151. Treas. Reg. §1.465-8(b)(2), Example (2).

152. See *Krause v. Comm'r,* 92 TC 1003 (1989).

CASH ACCOUNTING AND FARMING "SYNDICATES"

The TCJA allows most businesses with average annual gross receipts (AAGR) not exceeding $25 million to use the cash method of accounting.[153] The amount is adjusted for inflation and is $26 million for 2020.[154] Such businesses are also exempt from certain recordkeeping requirements, including the uniform capitalization rules,[155] specific inventory accounting rules,[156] business interest expense limits,[157] and certain long-term contracting requirements.[158] However, the use of cash accounting and the ability to utilize the exemptions are not available to a taxpayer that is a "tax shelter" regardless of whether the AAGR test is satisfied.[159]

FARM TAX SHELTER

The definition of **tax shelter** is found in IRC §461(i)(3). There is also a specific tax shelter rule for farming activities.[160] The term includes a partnership or other entity if a significant purpose is the avoidance or evasion of federal income tax.[161] In addition, a tax shelter is any enterprise (other than a C corporation) if interests in the enterprise have been offered for sale in any offering required to be registered with any federal or state agency having the authority to regulate the offering of securities for sale.[162] A farming syndicate is also a tax shelter.[163]

Note. Similar to the farming syndicate rule, an additional limitation is that a "tax shelter" on the cash method of accounting cannot deduct prepaid expenses until both "economic performance" occurs,[164] and the expenses are paid unless economic performance occurs within 90 days after the end of the tax year of payment.[165]

The maximum deduction allowable for prepaid expenses under this exception is the cash investment in the tax shelter by the taxpayer.[166]

A farm syndicate[167] includes any entity (other than a C corporation) engaged in the trade or business of farming (other than a C corporation), if more than 35% of the losses of the entity are allocable to limited partners or limited entrepreneurs **during any period.[168]**

Note. The mere **potential** for losses to be **allocated,** even though the entity reports income, could be enough to taint the entity as a farm syndicate. However, if the word "allocable" is read to mean "allocated," an entity is only a farm syndicate upon the entity reporting a loss that is allocated more than 35% to the limited partners or limited entrepreneurs.[169]

153. IRC §448(c).
154. Rev. Proc. 2019-44, 2019-47 IRB 1093.
155. IRC §263A.
156. IRC §471(c).
157. IRC §163(j).
158. IRC §460(e).
159. IRC §§448(a)(3) and 448(b)(3).
160. IRC §448(d)(3).
161. IRC §6662(d)(2)(C)(ii), referenced by IRC §461(i)(3)(C).
162. IRC §461(i)(3)(A).
163. IRC §461(i)(4).
164. IRC §461(h).
165. IRC §461(i)(2)(A).
166. For a case involving these issues, see *Agro-Jal Farming Enterprises, Inc., et al. v. Comm'r,* 145 TC 145 (2015).
167. There is also a separate definition for a non-farm syndicate. See IRC §461(i)(4).
168. IRC §461(k)(1)(B).
169. Once tainted, the entity will always be a farm syndicate, due to the "during any period" verbiage.

There are five exceptions to the 35% test for holdings attributable to "active management." An interest held by an individual who qualifies in any of these categories is treated as an interest that is not held by a limited partner or limited entrepreneur.[170]

1. In the case of any individual who has actively participated (for a period of not less than five years) in management of any trade or business of farming, any interest in a partnership or other enterprise that is attributable to such active participation
2. In the case of an individual whose principal residence is on a farm, any partnership or other enterprise engaged in the trade or business of farming such farm
3. In the case of any individual who is actively participating in the management of any trade or business of farming (or who is an individual described in items 1 or 2), any participation in the further processing of livestock that was raised in such trade or business (or in the trade or business referred to in the first two items)
4. In the case of an individual whose principal business activity involves participation in the management of a trade or business of farming, any interest in any other trade or business of farming
5. Any interest held by a member of the family (or a spouse of any such member) or a grandparent of an individual described in the above items, if the interest in the partnership or enterprise entity is attributable to the active participation of the individual described in the above items

Note. If the ownership interests of individuals who are not limited partners or limited entrepreneurs total at least 65%, the entity is not a farming syndicate.

As noted, if an "individual" has actively participated (for a period of not less than five years) in the management of the farming activity, any interest in a partnership or other enterprise that is attributable to that active participation is deemed to not be held by a limited partner or limited entrepreneur.[171] Thus, the interest does not count toward the 35% test.

While the IRS has taken the position that the active management exception only applies to an "individual," the U.S. Court of Appeals for the Fifth Circuit has held that the exception applied to a Texas cattle and horse breeding limited partnership where the majority owner's interest in the limited partnership via her S corporation was within the active management exception.[172] The ranching entity was owned 99% by an S corporation, which was owned 100% by the majority shareholder who ran the operation for a period of at least five years. The court noted that the Congressional intent behind the farming syndicate rule was to target high-income, nonfarm investors, not the type of taxpayer that the majority owner represented (the current majority owner of a family ranching operation that dated back to the 1800s who was actively managing the ranching operation). The court also noted that the statutory term "interest" was not synonymous with legal title or direct ownership, but rather was tied to involvement with or participation in the underlying business.

170. IRC §461(k)(2)(A)–(E).

171. IRC §461(k)(2)(A). Proposed guidance that was withdrawn in 1998 provided factors that indicated active participation. See Prop. Reg. §1.464-2(a)(3), **withdrawn by** 63 Fed. Reg. 71047 (Dec. 23, 1998). Under the proposed guidance, factors indicating active participation included participating in decisions involving the operation or management of a farm, actually working on the farm, living on the farm, or hiring and discharging employees. Factors indicating the lack of active participation included lack of managerial control and operation of the farm, having the authority only to discharge the farm manager, having a farm manager who is an independent contractor rather than an employee, and having limited liability for farm losses. In addition, IRC §464(c) was moved to IRC §461 in 2014.

172. *Burnett Ranches, Limited v. U.S.,* 753 F.3d 143 (5th Cir. 2014). The IRS has announced its disagreement with the court's decision. AOD 2017-01.

SELECTED ISSUES ASSOCIATED WITH LIKE-KIND EXCHANGES

The TCJA eliminated tax-deferred like-kind exchanges of personal property under IRC §1031 for exchanges completed after 2017. However, exchanges of **real estate** can still qualify for tax-deferred treatment if the exchange involves real estate that is "like-kind."[173]

The tax deferral of a §1031 exchange is only achieved if all the requirements of §1031 are satisfied. If the requirements are not satisfied, the exchange is taxable as a sale or exchange under the general rules of IRC §1001.[174]

There are **four basic requirements** to achieving tax-deferred treatment under §1031.[175]

1. There is an exchange of property rather than a sale.
2. The property exchanged and the property received must be like-kind real estate.
3. The property exchanged and the property received must both be held for productive use in a trade or business or for investment.
4. The exchange of properties must be simultaneous, or the replacement property must be identified within 45 days of the exchange and the identified property must be received within 180 days of the identification or the due date of the transferor's return (including extensions), if earlier.[176]

DEFINITION OF LIKE-KIND PROPERTY

Under the former rules governing trades of personal property, such as farm machinery, Treasury regulations determined if property was like-kind by reference to property within the same product class.[177] In addition, property was of a like-kind to property that was of the same nature or character.[178] However, like-kind personal property did not necessarily have to be of the same grade or quality. Thus, a like-kind exchange could involve a bull for a bull, a combine for a combine, but not a combine for a sports car or a farm or ranch for publicly traded stock. In addition, for intangible assets, the determination of like-kind (like classes are not allowed) had to be made on an asset-by-asset basis.[179]

With respect to real estate, a much broader definition of "like-kind" applies. Virtually any real estate used for business or investment can be exchanged for any other real estate if the exchanger continues to use the replacement property for business or investment. The regulations define "like-kind" in terms of reference to the nature or character of the replacement property rather than its grade or quality.[180]

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173. Adapted from *Obtaining Deferral for Non-Deferred Aspects of an IRC §1031 Exchange.* McEowen, Roger. May 21, 2020. Law Professor Blogs Network. [lawprofessors.typepad.com/agriculturallaw/2020/05/obtaining-deferral-for-non-deferred-aspects-of-an-irc-1031-exchange-.html] Accessed on Jul. 8, 2020. Used with permission from Law Professor Blogs Network.

174. Ibid.

175. IRC §1031(a)(1).

176. IRC §§1031(a)(3)(A)-(B)((ii). Generally, up to three properties can be exchanged. Treas. Reg. §1.1031(k)-1(c)(4)(i)(A). As an alternative, the taxpayer can identify any number of properties if their aggregate fair market value (as of the end of the identification period) does not exceed 200% of the FMV of the relinquished property. Treas. Reg. §1.1031(k)-1(c)(4)(i)(B).

177. See Treas. Reg. §1.1031(a)-2(b)(2).

178. See Treas. Reg. §1.1031(a)-2.

179. Treas. Reg. §1.1031(a)-2(c).

180. Treas. Reg. §1.1031(a)-1(b); see also CCA 201238027 (Apr. 17, 2012).

Proposed Regulations

On June 11, 2020, the Treasury Department issued proposed regulations defining "real property" for like-kind exchanges completed after 2017.[181] Prop. Treas. Reg. §1.1031(a)-3 defines real property as one of the following.

- Land
- Improvements to land
- Unsevered natural products of land
- Water and airspace adjacent to land

The definition includes interests in real property such as the following.

- Fee ownership
- Co-ownership
- A leasehold
- An option to acquire real property
- An easement
- A similar interest

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> **Note.** The proposed regulation states that local law definitions are **not** controlling for purposes of determining the meaning of the term **real property.** The regulation also makes clear that these definitions are **solely** for the purposes of §1031 and do not apply to other provisions in the Code.[182]

The proposed regulation also addresses the concept of a "distinct asset" and that a:

> *[D]istinct asset is analyzed separately from any other assets to which the asset relates to determine if the asset is real property, whether as land, an inherently permanent structure, or a structural component of an inherently permanent structure. Buildings and other inherently permanent structures are distinct assets. Assets and systems listed as a structural component in paragraph (a)(2)(iii)(B) of this section are treated as distinct assets.*[183]

The proposed regulation provides a test to determine if an item is a distinct asset for the purposes of the proposed regulations. Under the proposed regulation, the determination of whether a particular separately identifiable item of property is a distinct asset is based on all the facts and circumstances. In particular, the following factors must be taken into account.[184]

- Whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset
- Whether the item can be separated from a larger asset, and if so, the cost of separating the item from the larger asset
- Whether the item is commonly viewed as serving a useful function independent of a larger asset of which it is a part
- Whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset

181. REG-117589-18, 85 FR 35835.
182. Prop. Treas. Reg. §1.1031(a)-3(a)(1).
183. Prop. Treas. Reg. §1.1031(a)-3(a)(4)(i).
184. Prop. Treas. Reg. §1.1031(a)-3(a)(4)(ii).

Improvements to land include inherently permanent structures and structural components of inherently permanent structures.[185] The proposed regulation defines a **building** as "… any structure or edifice enclosing a space within its walls, and covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space."[186]

The regulations provide that buildings include the following distinct assets if permanently affixed.[187]

- Houses
- Apartments
- Hotels and motels
- Enclosed stadiums and arenas
- Enclosed shopping malls
- Factories and office buildings
- Warehouses
- Barns
- Enclosed garages
- Enclosed transportation stations and terminals
- Stores

Other **inherently permanent structures** include the following items if permanently affixed. [188]

- In-ground swimming pools
- Roads
- Bridges
- Tunnels
- Paved parking areas, parking facilities, and other pavements
- Special foundations
- Stationary wharves and docks
- Fences
- Inherently permanent advertising displays for which an election under IRC §1033(g)(3) is in effect
- Inherently permanent outdoor lighting facilities
- Railroad tracks and signals
- Telephone poles
- Power generation and transmission facilities

185. Prop. Treas. Reg. §1.1031(a)-3(a)(2)(i).
186. Prop. Treas. Reg. §1.1031(a)-3(a)(2)(ii)(B).
187. Ibid.
188. Prop. Treas. Reg. §1.1031(a)-3(a)(2)(ii)(C).

- Permanently installed telecommunication cables
- Microwave transmission
- Cell towers, broadcasting towers, and electric transmission towers
- Oil and gas pipelines
- Offshore drilling platforms, derricks, oil and gas storage tanks
- Grain storage bins and silos
- Enclosed transportation stations and terminals

The proposed regulation provides guidance to determine if an asset is permanently affixed.[189]

- The manner in which the distinct asset is affixed to real property
- Whether the distinct asset is designed to be removed or to remain in place
- The damage that removal of the distinct asset would cause to the item itself or to the real property to which it is affixed
- Any circumstances that suggest the expected period of affixation is not indefinite
- The time and expense required to move the distinct asset

Machinery is generally **not considered** part of real property because it is usually not an inherently permanent structure unless it is a structural component of a building that serves the inherently permanent structure and does not produce or contribute to the production of income other than for the use or occupancy of space.[190]

The proposed regulation defines a "structural component" as a distinct asset "that is a constituent part of, and integrated into, an inherently permanent structure."[191] The regulation notes that "[i]f interconnected assets work together to serve an inherently permanent structure (for example, systems that provide a building with electricity, heat, or water), the assets are analyzed together as one distinct asset that may be a structural component."[192] Additional detailed rules concerning a structural component are provided.[193]

Real property can also include "unsevered natural products of land," which includes the following. [194]

- Growing crops, plants, and timber
- Mines
- Wells
- Other natural deposits

Once such products have been severed, extracted, or removed from the land, they cease to be real property.[195]

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189. Ibid.

190. Prop. Treas. Reg. §1.1031(a)-3(a)(2)(ii)(D).

191. Prop. Treas. Reg. §1.1031(a)-3(a)(2)(iii)(A).

192. Ibid.

193. Prop. Treas. Reg. §§1.1031(a)-3(a)(2)(iii)(A) and (B).

194. Prop. Treas. Reg. §1.1031(a)-3(a)(3).

195. Ibid.

The proposed regulations also create a safe harbor for incidental amounts of personal property that are received in an exchange. Under the safe harbor, personal property is deemed to be incidental to real property acquired in an exchange if in standard commercial transactions, the personal property is typically transferred together with the real property and the aggregate fair market value (FMV) of the incidental personal property transferred with the real property does not exceed 15% of the aggregate FMV of the replacement real property.[196]

IRC §1245 TAX TRAP

It does not matter whether the real estate involved in a tax-deferred exchange is improved or unimproved.[197] Thus, agricultural real estate may be traded for residential real estate. However, if bare farmland is traded for farmland with depreciable structures on it, tax issues can arise. Many farm depreciable buildings and structures are IRC §1245 property. For example, commodity storage facilities and single-purpose agricultural structures are §1245 property, as are irrigation systems, drainage tile, and other improvements to farm real estate.

If property with a §1245 depreciation recapture attribute is disposed of in a like-kind exchange, the §1245 depreciation recapture must be recognized to the extent that the replacement property has insufficient §1245 property.[198] If replacement property has like-kind and similar improvements equal or exceeding that of the property disposed of, recapture may be avoided.[199] If improved property is exchanged for unimproved property, recapture as ordinary income may result regardless of the fact that an exchange occurred.

Example 10. Bob traded his real estate containing §1245 property with an adjusted basis of $200,000 for a like-kind property with an FMV of $180,000 and unlike-kind property with an FMV of $70,000.

Upon the exchange, $50,000 (($180,000 + $70,000) – $200,000) of gain is recognized because the property worth $70,000 is not §1245 (i.e., unlike-kind) property. The basis of the properties received in the exchange is $250,000 ($200,000 + $50,000). Of that amount, $70,000 is allocated to the property worth $70,000, and the $180,000 balance is allocated to the other property.

Observation. The result in this example is the same as a disposition by sale. There was no like-kind exchange tax-deferred benefit.

In some cases, IRC §1250 depreciable real property (e.g., machine shed, barn, shop, etc.) is transferred in an exchange. The amount of gain taken into account as recapture income is the larger of:

1. The gain recognized on the exchange, regardless of the recapture provision; **or**
2. The excess, if any, of the gain reported as ordinary income because of additional depreciation if the property had been sold **less** the FMV of the §1250 property acquired in the transaction.[200]

196. Prop. Treas. Reg. §1.1031(k)-1(g)(7)(iii).
197. Treas. Reg. §§1.1031(a)-1(b) and (c).
198. IRC §1245(b)(4).
199. Ibid.
200. IRC §1250(d)(4).

Example 11. On September 1, 2020, Chris P. Bacon exchanged his fee interest in a 45-acre farm with various improvements as identified in the following table (FMV of $400,000) for a fee interest in an 80-acre tract of bare farm real estate (FMV of $400,000). Chris intended the transaction to be a like-kind exchange. All property meets the definition of real estate. However, Chris is required to report the $170,000 gain recognized as §1245 depreciation recapture as taxable income. This is likely a surprising result, especially because no cash exchanged hands.[201]

Like-Kind Property	FMV	Basis	Gain Realized
Land (40 acres)	$185,000	$32,000	$153,000
Tile (SL depreciation)	15,000	0	15,000
Land/acreage (5 acres)	10,000	2,500	7,500
Machine shed (SL depreciation)	20,000	16,955	3,045
Total	$230,000	$51,455	$178,545

Unlike-Kind Property §1245 Recapture	FMV	Basis	Gain Realized
Well/water system	$ 3,500	$0	$ 3,500
Machine shed (accelerated depreciation, not SL)	6,500	0	6,500
Hog confinement building	125,000	0	125,000
Grain bins/drying system	35,000	0	35,000
Total	$170,000	$0	$170,000

He calculates his deferred gain as follows.

FMV	$400,000
Less: basis	(51,455)
Gain realized	$348,545
Less: gain recognized (§1245 recapture)	(170,000)
Gain deferred	$178,545

The basis of the property received is the basis of the exchanged §1250 property:[202]

1. **Decreased** by the amount of any money received that was not spent acquiring similar property;
2. **Increased** by the amount of gain recognized; and
3. **Decreased** by the amount of loss recognized. If more than one item of property of each type is received, the total basis is allocated to the individual items of property.

Note. The instructions for Form 8824, *Like-Kind Exchanges,* set forth the above rules and provide a location on the form for calculating the recapture amounts under both §§1245 and 1250.

201. This example is authored by David A. Brown, JD for inclusion in the Iowa Bar Tax Manual. The author of this chapter is also the editor of the Manual. Used with permission.

202. IRC §1031(d).

The recapture for §1250 property is deferred until a disposition of the acquired property occurs.[203] For real property, gain is recognized as recapture income in the exchange of like-kind assets to the extent that the amount of recapturable income exceeds the FMV of the acquired depreciable real property.[204] If gain is recognized on the exchange, recapture income is recognized to the extent of the greater of the gain recognized under the like-kind rules, or the amount of recapture income less the FMV of the acquired depreciable real property.[205]

THE "STRUCTURED" INSTALLMENT SALE

Interaction of IRC §§1031 and 453

If an exchange satisfies the requirements of §1031 but property is received that is not like-kind (such as money or other nonlike-kind property), the recipient of such property recognizes gain to the extent of the sum of the money and the FMV of the nonlike-kind property received.[206] Thus, tax deferral is not achieved with respect to the nonlike-kind property (or "boot") received in the exchange.[207]

However, a taxpayer may elect to recognize the gain on the boot under the installment method.[208] To be eligible to do so, the exchange must qualify under **both** §§1031 and 453. In that event, the taxpayer can achieve tax deferral on the entirety of the exchange. Similarly, a taxpayer that fails to satisfy the requirements of §1031 may be able to defer gain on the transaction under §453 by properly structuring the sale.[209]

> **Note.** IRC §453 (i.e., the installment method) is automatically triggered when a taxpayer disposes of property in a taxable transaction and at least one payment is to be received in a tax year after the year in which the transaction occurred. As a result, payments received are to be reported in the year of receipt.[210]

Rev. Rul. 65-155[211] involved a taxpayer who sold investment real estate. Gain was triggered on the sale, and the transaction qualified under §1031. The cash received along with the value of the similar property received in the year of the exchange did not exceed 30% of the entire amount received under the contract. The balance of the indebtedness was evidenced by a 5% interest-bearing note that was to be paid in annual installments over seven years. The IRS determined that the taxpayer could recognize the gain under the installment method as long as the requirements of §453 were satisfied.[212]

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203. IRC §1250(d)(4)(D). Treas. Reg. §1.1250-3(d)(5).
204. Ibid.
205. IRC §1031(b).
206. Ibid.
207. Adapted from *Obtaining Deferral for Non-Deferred Aspects of an IRC §1031 Exchange.* McEowen, Roger. May 21, 2020. Law Professor Blogs Network. [lawprofessors.typepad.com/agriculturallaw/2020/05/obtaining-deferral-for-non-deferred-aspects-of-an-irc-1031-exchange-.html] Accessed on Jul. 8, 2020. Used with permission from Law Professor Blogs Network.
208. IRC §453.
209. *Structured Sales: Breathing Life Into Installment Sales.* Wood, Robert W. [taxprof.typepad.com/taxprof_blog/files/2005-12400-1.pdf] Accessed on Jul. 14, 2020.
210. IRC §453(b)(1).
211. Rev. Rul. 65-155, 1965-1 CB 356.
212. See also Ltr. Rul. 8836006 (Jun. 6, 1988).

Treasury Regulation Example[213]

Treas. Reg. §1.1031(k)-(1)(j)(2)(vi), Example 4 indicates that a buyer's installment note issued to a seller qualifies for the installment treatment under §453. In the example, the buyer offered to buy the seller's real property but did not want to have the transaction structured as a like-kind exchange. As a result, the seller entered into an exchange agreement with a qualified intermediary to facilitate the exchange. Under the agreement, the seller transferred the real property to the qualified intermediary, who then transferred the property to the buyer. The buyer paid $80,000 cash and issued a 10-year installment note for $20,000.

The example specifies that the seller has a bona fide intent to enter into a deferred exchange, and the exchange agreement specifies that the seller cannot receive, pledge, borrow, or otherwise obtain the benefits of the money or other property that the qualified intermediary held until the earlier of the date the replacement property is delivered to the seller or the end of the exchange period. The example also states that the buyer's obligation bears adequate stated interest and is not payable on demand or readily tradable. The qualified intermediary acquires replacement property having an FMV of $80,000 and delivers it, along with the $20,000 installment obligation, to the seller.

Practitioner Planning Tip

The key phrase "not payable on demand or readily tradable" allows the use of a promissory note from the seller to retain installment sale treatment.

While $20,000 of the seller's gain does not qualify for deferral under §1031(a), the seller's receipt of the buyer's obligation is treated as the receipt of an obligation of the person acquiring the property for purposes of installment reporting of gain under §453. Thus, the example concludes that the seller may report the $20,000 gain on the installment method upon receiving payments from the buyer on the obligation.

Note. When §§1031 and 453 overlap with respect to a transaction, §1031 generally controls.[214] The regulations under §1031 have specific rules for determining gain or loss when both §§1031 and 453 apply. The §453 regulations generally defer to the §1031 regulations.[215] In an installment sale situation, the term "payment" generally does not include the receipt of evidence of indebtedness from the person acquiring the property.[216]

213. Adapted from *Obtaining Deferral for Non-Deferred Aspects of an IRC §1031 Exchange.* McEowen, Roger. May 21, 2020. Law Professor Blogs Network. [lawprofessors.typepad.com/agriculturallaw/2020/05/obtaining-deferral-for-non-deferred-aspects-of-an-irc-1031-exchange-.html] Accessed on Jul. 8, 2020. Used with permission from Law Professor Blogs Network.

214. Treas. Reg. §1.1031(k)-1(j)(1).

215. Treas. Reg. §15a.453-1(b)(3)(i).

216. Ibid.

Constructive Receipt

A cash-basis taxpayer takes income into account when it is actually received, as well as when it is **constructively** received.[217] Constructive receipt complicates cash accounting for many farmers and ranchers. Income is considered to be constructively received when it is credited to the taxpayer's account, set apart for the taxpayer, made available so the taxpayer can draw on it, or made available so the taxpayer can draw on it if notice of intent to withdraw is given.[218] However, income is not constructively received if the taxpayer's control of receipt is subject to substantial limitations or restrictions.[219]

Safe Harbor.[220] A safe harbor exists that provides protection against an IRS assertion that a taxpayer is in actual or constructive receipt of money or other property held in a qualified escrow account, qualified trust, or by a qualified intermediary.[221] With respect to a qualified intermediary, the determination of whether a taxpayer has received payment for purposes of §453 is made as if the qualified intermediary is **not** the taxpayer's agent.[222] Thus, when a taxpayer transfers property under such an arrangement and receives like-kind property in return, the transaction is an exchange rather than a sale, and the qualified intermediary is **not** deemed to be the taxpayer's agent.[223]

Similarly, when a buyer places money in an escrow account or with the qualified intermediary, the seller is **not** in constructive receipt of the funds if the seller's right to receive the funds is subject to substantial restrictions.[224] The regulations state that any agency relationship between the seller and the qualified intermediary is disregarded for purposes of §453 and Treas. Reg. §15a.453-1(b)(3)(i) in determining whether the seller has constructively received payment.[225]

> **Observation.** Constructive receipt rules do not prevent a taxpayer that receives payment in a future year in a deferred exchange from recognizing gain under §453 and reporting the gain on the installment method if the safe harbor requirements are satisfied.

Bona Fide Intent. A taxpayer must have a bona fide intent to enter into a deferred exchange at the beginning of the exchange period.[226] Intent is determined based on the facts and circumstances.[227] The fact that an exchange has been completed may be sufficient to establish intent at the time the exchange was entered into.[228]

The following example illustrates how an installment sale can be utilized in an exchange transaction that fails the requirements of §1031.

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217. See, e.g., *Romine v. Comm'r,* 25 TC 859 (1956) (check for hogs made available to taxpayer in 1946 but not received until 1947; income constructively received in 1946).

218. Treas. Reg. § 1.451-2(a).

219. Ibid. If the only limitation on the taxpayer's right to receive income during the tax year is a self-imposed limitation, that is insufficient for deferral purposes. See, e.g., *Scherbart v. Comm'r,* 453 F.3d 987 (8th Cir. 2000), *aff'g* TC Memo 2004-143 (co-op value-added payments not eligible for deferral; only limitation on receipt self-imposed and co-op held to be agent of taxpayer); *Walter v. U.S.,* 148 F.3d 1027 (8th Cir. 1998).

220. Adapted from *Obtaining Deferral for Non-Deferred Aspects of an IRC §1031 Exchange.* McEowen, Roger. May 21, 2020. Law Professor Blogs Network. [lawprofessors.typepad.com/agriculturallaw/2020/05/obtaining-deferral-for-non-deferred-aspects-of-an-irc-1031-exchange-.html] Accessed on Jul. 8, 2020. Used with permission from Law Professor Blogs Network.

221. Treas. Reg. §§1.1031(k)-1(g)(3)–(4); TD 8535 (Jan. 1994).

222. Treas. Reg. §§1.1031(k)-1(j)(2)(ii) and (g)(4).

223. See Ltr. Rul. 200327039 (Mar. 27, 2003)

224. See, e.g., *Stiles v. Comm'r,* 69 TC 558 (1978).

225. Treas. Reg. §1.1031(k)-1(j)(2)(vi), Example 2.

226. Treas. Reg. §1.1031(k)-1(j)(2)(iv).

227. Ibid. See e.g., *Smalley v. Comm'r,* 116 TC 450 (2001).

228. *Magneson v. Comm'r,* 753 F.2d 1490 (9th Cir. 1985).

Example 12. Molly Cule owns a tract of farmland that she uses in her farming business and would like to exchange it for other farmland in a like-kind exchange transaction. Bill Bored and Molly enter into a purchase contract, which provides that Bill will buy Molly's farmland. The purchase contract clearly states that Bill must accommodate Molly's desire to complete a like-kind exchange and states that Molly desires to enter into a like-kind exchange.

Molly and a qualified intermediary then enter into an exchange agreement specifying that the qualified intermediary will acquire Molly's farmland and transfer it to Bill. The agreement also states that the qualified intermediary will acquire like-kind farmland and transfer it to Molly. Molly assigns her rights in and to the farmland she gave up to the qualified intermediary. She also assigns her rights to the qualified intermediary in all contracts she enters into with the owner who holds title to the replacement farmland.

The exchange agreement requires Molly to identify replacement farmland within 45 days of the initial exchange and to notify the qualified intermediary of the identified parcel within that 45-day period. The exchange agreement allows Molly 180 days from the date of the first exchange to receive the identified replacement property.

The exchange agreement specifies that the qualified intermediary will sell Molly's farmland and hold the sales proceeds until the qualified intermediary buys replacement farmland. When the replacement farmland is purchased, it will then be transferred to Molly.

Note. If the sum of the aggregate cash consideration that the qualified intermediary pays for the purchase of the replacement farmland exceeds the cash proceeds from the sale of the relinquished property, Molly must provide the excess amount required to complete the purchase of the replacement property to the qualified intermediary. The qualified intermediary will hold the funds and, to deflect a potential IRS argument that she is in constructive receipt of the proceeds, Molly cannot have the ability to obtain any benefits from the property the qualified intermediary holds.

Structured Sale Aspect. The exchange agreement says that if the transaction qualifies under §1031 but Molly receives "boot," the qualified intermediary and Molly must engage in a structured sale for the boot. This is to bar Molly from having any right to receive cash from the exchange. Similarly, the exchange agreement contains additional language stating that if the transaction fails to qualify for §1031 treatment for any reason, the qualified intermediary and Molly must engage in a structured sale.

The structured sale involves the qualified intermediary making specified periodic payments to Molly pursuant to an installment sale agreement (based on the consideration the qualified intermediary holds), coupled with a note for a set number of years. Thus, the exchange agreement is drafted to specify that if an installment sale results, Molly will report each payment received in income in the year she receives it.

The Assignment Agreement. If the installment sale language is triggered, the exchange agreement specifies that the qualified intermediary assigns its obligations to make the periodic payments under the installment note to an assignment company pursuant to a separate assignment agreement between the qualified intermediary and the assignment company. Molly is not a party to this agreement.

The assignment agreement requires the qualified intermediary to transfer a lump sum to the assignment company. The lump sum amount equals the discounted present value of the stream of payments that the qualified intermediary must make under the installment note and exchange agreement. In return, the assignment company assumes the qualified intermediary's obligation to pay Molly. Thus, the assignment company becomes an obligor under the installment note.

Note. An assignment company often buys an annuity contract from an insurance company that names the assignment company as the buyer. The seller of the real property (Molly, in the example) is designated as the beneficiary.

As discussed earlier, Example 4 of Treas. Reg. §1.1031(k)-1(j)(vi) involves an installment note that the buyer issues to the seller of the property. That note qualifies for installment treatment under §453. In **Example 12,** it is the qualified intermediary that issues the note. While the regulations provide that the qualified intermediary is not the agent of Molly for purposes of §453, that is only the case until the earlier of the identification (or replacement) period, or the time that Molly has the unrestricted right to receive, pledge, borrow, or otherwise benefit from the money or other property that the qualified intermediary holds.[229]

Thus, if the qualified intermediary distributes the installment note **after** the exchange period expires, an agency relationship could be found to exist and the IRS could claim that Molly obtained the benefit of the cash that the qualified intermediary holds. Such an assertion would be based on the notion that the qualified intermediary can only issue a note because it is the buyer's cash that the qualified intermediary is holding.

> **Note.** The risk of the IRS asserting that Molly is in constructive receipt of the buyer's funds is eliminated if, under the terms of the exchange agreement, Molly agrees to receive periodic payments attributable to any boot triggered on the exchange or to the extent the exchange fails the §1031 requirements. Under the regulation's safe harbor, at the time Molly enters into the exchange agreement she becomes contractually bound by it and the qualified intermediary is not Molly's agent. Molly is contractually barred from having access to the cash involved in the exchange or deriving any benefit from it.

The occurrence of a structured installment sale upon the contingency and to the extent of a failed §1031 exchange does not negate Molly's intent to enter into a tax-deferred exchange.[230] This is especially true if the exchange agreement is drafted to evidence Molly's intent as such when the exchange is entered into.[231] This contractual language also does not trigger the cash equivalency doctrine.[232] Questions of cash equivalency arise primarily with intangible property, such as contract rights, accounts receivable, and promissory notes. Courts have generally interpreted the applicable Code sections and regulations to exclude from income the receipt of certain intangible property that is deemed **not** the equivalent of cash.[233] Similarly, because Molly is not a party to the transaction between the assignment company and the buyer, the economic benefit doctrine should not apply.[234] The doctrine of economic benefit requires a determination that the actual receipt of property or the right to receive property in the future confers a current economic benefit on the recipient. Economic benefit applies when assets are unconditionally and irrevocably paid into a fund or trust to be used for a taxpayer's sole benefit.[235]

Alternative Approach. There is an alternative to the approach taken in **Example 12** involving Molly.

Example 13. Millie is engaged in a similar transaction to the one that Molly engaged in. Millie used installment reporting but received all of the cash up front via a loan.[236]

Millie sells an asset to Howard's Exchange Service (HES) and HES resells the asset to Andy. Millie receives a loan from Usurious Bank, an independent lender, shortly after selling the asset to HES for an amount equal to the selling price. The repayment of the loan is funded by installment payments over 30 years that HES makes to Usurious Bank.

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229. Treas. Reg. §1.1031(k)-1(j)(2)(ii).

230. See, e.g., *Smalley v. Comm'r,* 116 TC 450 (2001).

231. Ibid.

232. See, e.g., *Reed v. Comm'r,* 723 F.2d 138 (1st Cir. 1983).

233. CCA 200151003 (Dec. 21, 2001).

234. See, e.g., *Sproull v. Comm'r,* 16 TC 244 (1951).

235. Ibid.

236. Adapted from *Obtaining Deferral for Non-Deferred Aspects of an IRC §1031 Exchange.* McEowen, Roger. May 21, 2020. Law Professor Blogs Network. [lawprofessors.typepad.com/agriculturallaw/2020/05/obtaining-deferral-for-non-deferred-aspects-of-an-irc-1031-exchange-.html] Accessed on Jul. 8, 2020. Used with permission from Law Professor Blogs Network.

Three escrow accounts are established with an escrow company affiliated with Usurious Bank. The escrow company, on a monthly basis, takes funds from HES and moves it into Escrow Account No. 1 as an interest payment on the loan; then to Escrow Account No. 2 (which is designated as Millie's account); and then to Escrow Account No. 3 to pay interest on the loan. The transactions are conducted as automatic debit/credit transactions that occur on a monthly basis over the length of the installment period.

Note. From an economic standpoint, Millie receives cash upfront in the form of a loan and has a "wash" (or nearly so) on the interest income and interest expense on the monthly escrow transactions. Millie pays capital gain tax in the last year of the installment period, with the loan proceeds received in the year of sale used as the source of the funds to pay the tax.

Analysis. For the seller to receive installment treatment on the proceeds of the sale, §453 requires that the initial debt obligation be that of the buyer of the property. If the obligor is someone other than the buyer, the debt is treated as payment on the sale.[237] Thus, for installment sale treatment to result, HES must be both the buyer of the asset and the obligor on the installment note rather than only being the obligor. To achieve installment sale status, the transaction must be structured such that the obligation is due to Millie from Andy, followed by a substitution of the obligor via an independent transaction in which Andy assigns the obligation.[238]

Note. In Rev. Rul. 82-122,[239] the substitution of a new obligor on the note and an increase in the interest rate, together with an increase in the amount paid monthly to reflect the higher interest rate, was not considered to be a satisfaction or disposition of an installment obligation within the meaning of IRC §453B(a).

For escrow accounts, generally an installment note of the buyer cannot be used as security or pledged to support any other debt that benefits the seller. If that happens, the net proceeds of the debt are treated as a payment received on the installment sale.[240] However, there is an exception to this "pledge rule" that triggers gain recognition if the seller uses an installment obligation to secure a loan. Property that is used or produced in the trade or business of farming is not subject to the rule.[241] Thus, a taxpayer who sells farmland (or other farm property) in an installment sale may use that installment receivable as security, or in a pledged manner, to borrow funds from a third party. The third party should collateralize the payments and file a Uniform Commercial Code-1 form to formally pledge the installment payments.[242]

Note. Apparently, the exception is based on the recognition that farmers routinely use the installment method of reporting income when selling grain and other products produced in the business of farming. Therefore, they should be able to utilize that same method of reporting income when borrowing from third-party lenders.

237. Treas. Reg. §15a.453-1(b)(3)(i).

238. See, e.g., Rev. Rul. 82-122, 1982-1 CB 80, amplifying Rev. Rul. 75-457, 1975-2 CB 196.

239. Ibid.

240. IRC §453A(d)(1); Treas. Reg. §15A.453-1(b)(3)(i); Rev. Rul. 79-91, 1979-1 CB 179; Rev. Rul. 77-294, 1977-2 CB 173; Rev. Rul. 73-451, 1973-2 CB 158.

241. IRC §453A(b)(3)(B).

242. Adapted from *Obtaining Deferral for Non-Deferred Aspects of an IRC §1031 Exchange.* McEowen, Roger. May 21, 2020. Law Professor Blogs Network. [lawprofessors.typepad.com/agriculturallaw/2020/05/obtaining-deferral-for-non-deferred-aspects-of-an-irc-1031-exchange-.html] Accessed on Jul. 8, 2020. Used with permission from Law Professor Blogs Network.

AGRICULTURAL RULINGS AND CASES

BANKRUPTCY

PPP Loan Eligibility

***Schuessler v. U.S. SBA,* No. 20-02065-bhl; U.S. Bankruptcy Court for the Eastern District of Wisconsin (May 22, 2020)**

The debtors, a married couple operating a dairy farm, filed Chapter 12 bankruptcy in late 2018. On the same day, their wholly owned LLC that runs the farming and dairy operation filed a separate Chapter 12 petition. The debtors direct the farming operation and own the real estate and improvements. The cases were jointly administered, and the debtors' second amended plan was confirmed on May 8, 2019. The debtors' income comes primarily from milk sales and from the sale of culled cows.

Due to the present economic crisis stemming from COVID-19, the debtors' milk sale revenue declined by more than 30%. Since January 2019, the wholesale price of milk declined from nearly $19.00 to $12.50 per hundredweight. In addition, due to slaughterhouse closures, the debtors received much lower than historical prices for their culled cow sales. The debtors listed significant mortgage and utility expenses on the bankruptcy schedules and noted that they employ 14 people with an average monthly payroll of $59,835.

The debtors applied for a PPP loan from the SBA and were rejected because of their pending bankruptcy case. They otherwise met the requirements of the PPP. Without the loan, the debtors predicted they would be forced to lay off essential employees and would be potentially driven out of business.

The debtors then filed for declaratory judgment, writ of mandamus, and injunctive relief against the SBA. The bankruptcy court rejected the debtors' claims and dismissed the complaint. The bankruptcy court noted that the SBA's fourth interim final rule, section III (4), specified that a debtor in bankruptcy is **not eligible** for a PPP loan.

The issue was whether the SBA's position violated the antidiscrimination provisions contained in 11 USC §525(a). Those provisions bar the government from revoking, suspending, or refusing to renew "a license, permit, charter, franchise, or other similar grant" based on a person either being in or having been a debtor in bankruptcy.

The bankruptcy court noted that the U.S. Court of Appeals for the Seventh Circuit (to which any appeal would be made) had not yet ruled on the scope of 11 USC §525(a), but that four other circuit courts of appeal had. Three of those courts took a narrow view of 11 USC §525(a) and only the U.S. Court of Appeals for the Second Circuit determined that debtors in bankruptcy could not be denied any "property interests" that were essential to the debtor's "fresh start" in bankruptcy.[243] The bankruptcy court also agreed with the SBA's reliance on other courts that had recently held that the denial of PPP eligibility to bankrupt debtors **did not violate** 11 USC §525(a) because the PPP funds are distributed via "loans" and are, as a result, outside the scope of the antidiscrimination provisions of 11 USC §525(a).[244]

In addition, the bankruptcy court noted that in *In re Elter,*[245] the refusal to extend a government-guaranteed student loan based on the debtor's bankruptcy history **did not violate** 11 USC §525(a). It was the plain terms of the CARES Act creating the PPP as a subsidized loan guarantee program, the bankruptcy court reasoned, that kept it beyond the antidiscrimination provisions of 11 USC §525(a) that applied to a "license, permit, charter, franchise, or other similar grant."

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243. *Stolz v. Brattleboro Housing Authority,* 315 F.3d 80 (2d Cir. 2002).

244. See *Cosi, Inc. v. SBA,* Adv. No. 20-50591 (Bankr. D. Del. 2020); *Trudy's Texas Star, Inc. v. Carranza,* Adv. No. 20-1026 (Bankr. W.D. Tex. 2020).

245. *In re Elter,* 95 BR 618 (Bankr. E.D. Wis. 1989).

While the underlying statute[246] is silent on whether bankrupt debtors are ineligible for PPP loans, the bankruptcy court noted that there was nothing in the statute that suggested Congress intended to limit the SBA's rulemaking or that Congress provided an exhaustive list of eligibility requirements that the SBA could not supplement via rulemaking. Thus, the fourth interim final rule was not beyond the SBA's delegated authority. In addition, the court held that the fourth interim final rule did not violate the Administrative Procedure Act for being arbitrary and capricious. The bankruptcy court noted that if Congress had intended to bar the SBA from denying loan eligibility to applicants in bankruptcy, it could have done so.

> **Note.** The bankruptcy court's decision runs counter to two other bankruptcy court decisions on the PPP eligibility issue — a bankruptcy court in Texas and one in Vermont.[247] Indeed, the Texas bankruptcy court also noted the lack of collateral requirements to obtain a PPP loan and that the funds need not be repaid if they were used in a qualified manner, illustrating the minimal risk to a lender of a borrower's default.

Cram-Down Interest Rate Determined

***In re Country Morning Farms, Inc.,* No. 19-00478-FPC11; U.S. Bankruptcy Court for the Eastern District of Washington (Feb. 4, 2020)**

The debtor filed Chapter 11 bankruptcy. The debtor and the bank could not agree on the appropriate interest rate to be used in the debtor's reorganization plan. The parties agreed that the "prime plus" method set forth in *Till v. SCS Credit Corp.*[248] was the appropriate method to determine the "cram down" interest rate."

The parties agreed that the prime rate was presently 4.75% and that an additional amount as a "risk factor" should be added to the prime rate. The debtors proposed a 6% interest rate, based on the risk associated with their dairy business. The bank claimed that the appropriate interest rate was 7.75% — the highest rate factor available under the *Till* analysis. The bank cited the length of the plan, the volatility of the dairy market, the debtor's capital structure, and conflicting projections from an expert when determining the appropriate risk factor. The court determined that the appropriate interest rate was 7%, which raised the interest rate on some of the debtor's loans and lowered it on others.

CONSERVATION EASEMENTS

Extinguishment Regulation Upheld

***Oakbrook Land Holdings, LLC v. Comm'r,* 154 TC No. 10 (May 12, 2020); *Oakbrook Land Holdings, LLC v. Comm'r,* TC Memo 2020-54 (May 12, 2020)**

In 2008, the petitioner donated a permanent conservation easement to a qualified organization and claimed a charitable deduction. The easement deed specified that upon extinguishment of the conservation restriction, the donee would receive a share of the proceeds equal to the FMV of the easement as of the date of the contribution. That value, the deed specified, was to be reduced by the value of any improvements that the donor made after granting the easement. The IRS denied the charitable deduction because the deed violated the extinguishment regulation of Treas. Reg. §1.170A-14(g)(6).

The full Tax Court, agreeing with the IRS, upheld the validity of the regulation on the basis that the extinguishment regulation[249] had been properly promulgated and did not violate the Administrative Procedure Act. The full Tax Court also determined that the construction of §170(h)(5), as set forth in the extinguishment regulation, was valid under the agency deference standard set forth in *Chevron, U.S.A. v. Natural Resources Defense Council, Inc.*[250]

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246. 15 USC §636(a)(36)(F)(i).

247. See *Hidalgo County Emergency Service Foundation v. Carranza,* Adv. No. 20-2006, 2020 Bankr. LEXIS 1174 (Bankr. S.D. Tex. 2020); and *In re Springfield Hospital, Inc.,* No. 19-10283, 2020 Bankr. LEXIS 1205 (Bankr. D. Vt. 2020).

248. *Till v. SCS Credit Corp.,* 541 U.S. 465 (2004).

249. Treas. Reg. §1.170A-14(g)(6).

250. *Chevron, U.S.A. v. Natural Resources Defense Council, Inc.,* 467 U.S. 837 (1984).

In a related memorandum opinion, the Tax Court held that the easement deed did not create a perpetual easement because the donee's share of the extinguishment proceeds was based on fixed historical value, reduced by the value of improvements that the donor made. It was not, as it should have been, based on a proportionate share of extinguishment proceeds that are at least equal to the total proceeds (unadjusted by the value of the petitioner's improvements), multiplied by a fraction defined as the ratio of the FMV of the easement over the FMV of the unencumbered property determined as of the date of the execution of the deed. However, the Tax Court did not uphold penalties that the IRS imposed, finding that the petitioner's position was reasonable.

Conservation Easement Deduction Reduced; Farm-Related Expenses Denied

***Johnson v. Comm'r,* TC Memo 2020-79 (Jun. 8, 2020)**

The petitioner was the president of a west-central Colorado company that manufactures and sells disposable ink pans for printing presses. He purchased a 121-acre ranch in 2002 for $200,000. The ranch was a combination of pasture and naturally vegetated riparian wetlands that included 25 acres of irrigated fields and dedicated water rights and another 25 acres of subirrigated pastures that drew water from nearby water sources. The ranch also had a wide variety of wildlife.

The petitioner used the ranch for agricultural activities such as cattle ranching and farming, including hay production. He also built a 3,500 square-foot single-family house and several outbuildings on the ranch to use for his farming and ranching activities, including a barn, hay shed, loafing shed, and a shop where he could repair and weld farm equipment.

In 2007, the petitioner carved out a permanent conservation easement to the Colorado Open Lands, a qualified charity. He made the donation in 2007. The easement encumbered 116.14 acres along with the water rights, leaving the remaining five acres unencumbered. The easement restricted the encumbered area from being subdivided, used as a feedlot, or used for commercial activities. It also restricted all construction within the encumbered area except for a 5-acre area that was designated a "building envelope." The deed limited constructed floor space inside the building envelope to 6,000 square feet for single residential improvements and a cumulative maximum of 30,000 square feet for all improvements.

On his tax return for 2007, the petitioner claimed a $610,000 charitable contribution deduction for the donated easement, with carryover amounts of $265,051 deducted in tax years 2007–2011. Those carryover amounts were not in controversy. However, he also deducted $178,628 over the years 2012–2014.

The IRS denied the carryover charitable deductions in these years on the basis that he had already deducted more than the easement's value for previous tax years. The petitioner and the IRS agreed that the property's highest and best use was for farming and a residence. The petitioner's valuation expert used a quantitative approach by taking comparable sales adjusted by time between the date of those easement donations and when the petitioner donated his easement. The petitioner's expert then adjusted for nearness of the encumbered property to town and size. He then factored in irrigation, topography, and improvements to arrive at the value of the property before the easement. The expert did not have many post-donation comparable sales to work with in arriving at the value of the petitioner's property after the easement donation.

The valuation expert for the IRS used the qualitative approach. That approach involved comparing several characteristics for each comparable sale — including market conditions at the time of sale, location/access, size, aesthetic appeal, zoning, and available utilities — to evaluate the relative superiority, inferiority, or similarity of each comparable property to the ranch. The expert then evaluated the overall comparability of each property to the ranch.

The Tax Court preferred the approach of the petitioner's expert, due to the IRS's expert ignoring the quantitative factors. However, the Tax Court adjusted the value arrived at by the petitioner's expert. Post-encumbrance nearby comparable sales were lacking, and the Tax Court rejected both experts' post-encumbrance direct comparable sales analyses. After ignoring an outlier from both of the experts, the parties were only 2% apart on value. The Tax Court split the difference between the parties and added it to the pre-easement value as adjusted to arrive at the easement's value. Thus, the Tax Court allowed a $373,000 deduction for the easement.

For 2012–2014, the petitioner also claimed certain farm-related expenses. Relevant to this issue was the petitioner's move in 2011 to a location about 120 miles south of the ranch so that he could be closer to an airport for purposes of travel associated with his manufacturing business and because of an economic downturn in the economy near the ranch that impacted the quality of schools for his children. By the time he moved, the petitioner had phased out his cattle ranching activity, but he sharecropped hay from the ranch with a neighbor. He also drove to and from the ranch to deal with irrigation issues. The haying activity allowed him to preserve his water rights; if he did not use the rights every year, he would lose them. For 2012–2014, the petitioner fully offset his Schedule F income with farming expense deductions including office supplies, car and truck expenses, repairs and maintenance, meals, accounting fees, gas, other fuel and oil, insurance, travel, and depreciation.

The Tax Court, agreeing with the IRS, denied various farming expense deductions including travel-related expenses due to a lack of substantiation.

EXPENSES

Start-Up Expenses — Thinning of Maple Forest for Blueberry Production

***Primus v. Comm'r,* TC Summ. Op. 2020-2 (Jan. 7, 2020)**

The petitioner lived in New York and bought a property in Quebec containing 200 maple trees. A significant number of the trees were mature, maple syrup-producing trees. The tract contained other types of trees, pasture ground, and hay fields and 12 acres suitable for growing crops. There were also various improvements on the tract.

Before collecting sap and producing syrup, the petitioner thinned underbrush and later installed a pipeline to collect sap. Sap production began in 2017.

When the petitioner bought the property in 2012, he cleared the areas of the tract where he planned to plant blueberry bushes. He ordered 2,000 blueberry bushes in 2014 and planted them in 2015.

On his timely filed tax returns for 2012 and 2013, the petititioner reported a substantial amount of farming-related expenses. Most of the expenses were attributable to costs of repairs to improvements on the property.

The petitioner deducted expenses attributable to preparation for producing and selling maple syrup and blueberries as trade or business expenses under IRC §162 (or as IRC §212 expenses for income-producing property). The IRS denied the deductions, asserting that they were nondeductible startup expenses under IRC §195 on the basis that the petitioner had not yet begun the business of producing maple syrup and blueberries.

The Tax Court upheld the IRS's position. The Tax Court noted expenses are not deductible as trade or business expenses until the business is actually functioning and performing the activities for which it was organized. The court noted that the petitioner had not actually started selling blueberries or sap in either 2012 or 2013. Accordingly, the 2012 and 2013 expenses were incurred to prepare the farm to produce sap and plant blueberries and were nondeductible startup expenses. The thinning activities, while a generally acceptable industry practice, did not establish that the business had progressed beyond the startup phase. In addition, during the years at issue, the petitioner had not collected sap, installed any infrastructure needed to convert sap into syrup, or bought any blueberry bushes.

Travel Expenses to Care for Timber Property Allowed

***Maki v. Comm'r,* TC Summ. Op. 2019-34 (Nov. 4, 2019)**

In the 1980s, the petitioner inherited timber property from his mother. He traveled weekly to care for and monitor the timber on the property. He also planted additional trees. Each roundtrip was about 300 miles. The trees appreciated in value, reaching an approximate harvest value exceeding $1 million.

During a period when he was physical unable to travel to the property and monitor the trees, some of the trees were illegally harvested.

He maintained a daily log of his trips and activities associated with the property. After preparing a summary of his 2013 visits for the IRS from the logs, the original records were lost due to vandalism of the building in which they were stored. According to the summary, the petitioner was present at the property during 161 days in 2013, via 47 roundtrips from his residence. For 2013, the petitioner did not have any timber income from the property but did claim $7,011 of travel expenses and $55,925 of per diem expenses.

The IRS denied the travel and per diem expenses that were claimed on the return on the basis that the expenses were not ordinary and necessary business expenses and/or were not sufficiently substantiated. The Tax Court disagreed with the IRS with respect to the travel expenses, concluding that the petitioner had a repetitive, routine, and predictable travel pattern that was sufficiently substantiated and the travel expenses were incurred to protect the property, which is a legitimate business purpose. However, the Tax Court allowed only $7,406 of per diem expenses because the petitioner used the incorrect per diem rate.

HOBBY LOSSES

Cutting Horse Activity not a Hobby

***Besten v. Comm'r,* TC Memo 2019-154 (Nov. 25, 2019)**

The petitioner operated a seed business and engaged in "cutting" horse activity. Based on an analysis of the nine factors in the regulations under IRC §183, the petitioner was able to establish that the horse activity involving breeding, raising, boarding, training, and selling registered cutting horses qualified as a for-profit activity. Notably, although the taxpayer failed to support his claim that the seed business and the horse activity should be treated as a single activity, even standing alone, the evidence established that the horse activity was undertaken with the requisite profit objective.

The petitioner had a business plan for the activity, kept activity records consistent with his profit objective, changed and scaled down operations in an attempt to accommodate economic realities, and actively marketed the activity. This indicated that the petitioner conducted the horse activity in a businesslike manner. In addition, the petitioner had expertise in horse operations and hired a network of trainers to assist him, spent considerable time on the activity, had success in other businesses, and did not engage in the activity solely for pleasure. Instead, the petitioner rode horses to train them and otherwise worked to prepare them for competition.

Although the petitioner had income from his seed business that was offset by the horse activity losses, the Tax Court found that he was not in the financial position to continue suffering horse activity losses without a bona fide profit motive and concluded that his claim of a bona fide profit objective outweighed the countervailing factors regarding his loss history and lack of occasional profit during the years at issue. However, the Tax Court did deny some deductions for expenses that had both personal and business characteristics or were not shown to have cleared his bank account.

> **Note.** For a detailed explanation of the factors involved in determining whether an activity is a trade or business or a hobby, see the 2020 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Small Business Issues.

Horse Activity Not Trade or Business Without a Horse

McMillan v. Comm'r, **TC Memo 2019-108 (Aug. 26, 2019)**

During 2010, the year in issue, the petitioner worked 5–6 hours daily at her job and was heavily involved in litigation against her homeowner's association. She claimed deductions associated with her horse breeding and showing activity and the IRS denied the deductions. The Tax Court upheld the IRS position largely because the petitioner did not establish that the activity had begun in 2010. She did not own any horses during 2010 and did not breed or show any horses during 2010. The petitioner also did not participate in any horse competitions during the year.

The Tax Court concluded that the activity, if there was one, is deemed to not be conducted with a profit motive. Thus, deductions associated with the activity were disallowed. The Tax Court noted that the petitioner could have deductible startup expenses in accordance with IRC §195 when the activity actually began.

Expert Witness Report Properly Excluded in Hobby Loss Case

Skolnick v. Comm'r, **TC Memo 2019-64 (Jun. 3, 2019)**

At issue was whether the petitioners conducted a horse-related activity with a profit intent. The IRS moved to exclude from evidence the taxpayer's expert witness report concerning the value of the horses on the basis that the report failed to satisfy Federal Rule of Evidence 702 or Tax Court Rule 143 by not detailing facts or data on which the expert relied. The report also did not identify principles and methods the expert employed or show that the expert applied the methods in a reliable way.

A thumb drive allegedly containing the data had been given to the IRS, but it was not contained in the expert's report. The thumb drive was given to the IRS only days before trial and contained massive amounts of data on many horses, not just the ones at issue in the litigation.

The Tax Court granted the IRS's motion to exclude the petitioner's expert witness report.

Horse Activity Triggers Hobby Loss Rule

Sapoznik v. Comm'r, **TC Memo 2019-77 (Jun. 19, 2019)**

The petitioners bought a horse in 2011 and participated in horse shows in 2014 and 2015. The horse was top 10 in its class nationally, and the petitioners hoped to be able to sell the horse for a profit. However, they lost more than $100,000 and sold the horse for what they paid for it. The petitioners deducted the $100,000 loss, and the IRS rejected the deduction and assessed a penalty exceeding $6,000.

The Tax Court agreed with the IRS that the hobby loss rules under §183 were not satisfied because the petitioners had not engaged in the activity with a profit intent. The Tax Court noted that the petitioners had not conducted the activity in a businesslike manner. They had no written business plan and did not keep accurate books and records. They also made no changes in how they conducted the activity to reduce expenses or generate additional income and did not attempt to educate themselves on how to conduct the activity. They also did not rely on the activity as a major source of their income and never came close to making a profit.

Decades of Losses Result in Application of Hobby Loss Rules

Donoghue v. Comm'r, **TC Memo 2019-71 (Jun. 11, 2019)**

The petitioners, a married couple, sustained losses in their horse breeding/racing activity for almost 30 years without ever showing a profit. The husband was a computer programmer and his wife was a retired paralegal and business executive. The wife had been a life-long horse enthusiast. They operated the activity via a partnership as a "virtual farm." The IRS denied the loss deductions from the activity for particular years.

The Tax Court agreed with the IRS on the basis that the petitioners could not satisfy the requirements of the regulations under §183. The Tax Court noted that the evidence was clear that the petitioners did not operate the activity in a business-like manner. The petitioners did not breed, race, or sell any of their horses during the years at issue. While they had separate bank accounts and some records for the horse activity, the records were incomplete or inaccurate. The petitioners had written business plans, but the plans projected net losses and remained essentially unchanged from the original plans 30 years earlier. The petitioners' long string of unbroken losses were used to offset nonfarm income, and they derived substantial personal pleasure from the activity. They left the "grueling aspects" of the activity to others they paid, and there was no evidence that they sought expert advice concerning how to make a profit at the activity. Instead, they sought only general advice.

IRS DEVELOPMENTS

Annual Adjustment to Credit for Oil and Gas Production

IRS Notice 2020-34, 2020-21 IRB 838

The IRS published the applicable reference price under IRC §45I for qualified natural gas production from qualified marginal wells for calendar year 2019. The figures are used to compute the credit that is allowed for sales of fuel produced from a nonconventional source. The applicable reference price for tax years beginning in calendar year 2019 is $2.55 per 1,000 cubic feet. The credit is $.08 per 1,000 cubic feet of qualified natural gas produced from marginal wells.