Chapter 5: Agricultural Issues and Rural Investments

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Please note. Corrections were made to this workbook through January of 2022. 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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PPP AND ERC: UNRESOLVED ISSUES

PPP: BACKGROUND

The Paycheck Protection Program (PPP) provides loans guaranteed by the Small Business Administration (SBA). Eligible borrowers include eligible individuals and entities receiving loans based upon 2.5 months of average payroll costs of the employer. Payroll for this purpose does not include compensation exceeding $100,000 per employee.[1]

A PPP loan borrower qualifies for forgiveness upon incurring and paying payroll costs, certain interest expenses, covered rent, and other qualified costs during an 8- or 24-week covered period.[2]

Payroll costs include Form W-2, *Wage and Tax Statement,* wages, group health care benefits, payment of retirement benefits, and state and local taxes assessed on the compensation of employees, as well as payments of compensation to or income of a sole proprietor.[3]

Loan Forgiveness

In General. A borrower must submit to the lender an application for forgiveness, documenting the full-time equivalent (FTE) employees, pay rates, and payment of qualified costs.[4] The forgiveness is reduced if the borrower fails to maintain or achieve FTE employee thresholds and pay levels.[5] Forgiveness is also reduced to the extent the borrower's payroll costs were not at least 60% of the loan amount.[6]

Note. No borrower should receive forgiveness without submitting to the lender the required documentation.[7] In addition, a borrower may apply for forgiveness as late as 10 months after the end of the covered period to avoid making payments.[8] PPP loans not exceeding $150,000 qualify for a simplified forgiveness process using SBA Form 3508S, *PPP Loan Forgiveness Application*.

1. *CARES Act,* PL 116-136, §1102(a) as interpreted by SBA Interim Final Rules (IFRs).
2. *CARES Act,* PL 116-136, §1106(b); *Paycheck Protection Program Flexibility Act of 2020* (PPPFA), PL 116-142, §3(b).
3. *CARES Act,* PL 116-136, §1102(a).
4. *CARES Act,* PL 116-136, §1106(e).
5. *CARES Act,* PL 116-136, §1106(d).
6. *Paycheck Protection Program Flexibility Act of 2020,* PL 116-142, §3(b).
7. *CARES Act,* PL 116-136, §1106(f).
8. SBA IFR issued Jun. 11, 2020, III.1.c, pp. 7–8.

The lender is allowed 60 days to act on the application for forgiveness[9] and the SBA is to act within 90 days after the lender issues its decision to the SBA. The lender is responsible for notifying the borrower of remittance by the SBA of the loan forgiveness amount.[10]

Any amount that would be includible in the borrower's gross income by reason of forgiveness is excluded from gross income.[11]

Impact on S Corporations and Shareholders. Shareholders of an S corporation may deduct their allocated share of the S corporation's loss to the extent of their basis in the S corporation's stock and in debt owed directly to the shareholder.[12] The accumulated adjustments account (AAA) represents an account of the S corporation that is adjusted for the S corporation period.[13] All S corporations start with an AAA balance of zero on the first day of the first S corporation year.[14]

The AAA is increased and decreased by the same adjustments that affect shareholder basis, except that no adjustment is made for tax-exempt income and related expenses.[15] PPP loan forgiveness income is treated as tax-exempt income.[16]

Items that increase basis but not AAA are assigned to the other adjustments account (OAA). Adjustments that increase OAA increase basis in stock for the shareholders but are not available for distribution until the S corporation has fully distributed its accumulated earnings and profits.[17] Thus, qualified PPP expenses that are deducted and are attributable to a PPP loan should not be taken into account for the AAA under IRC §1368(e)(1)(A). Rather, the OAA should include such related expenses because they directly relate to the loan forgiveness (tax-exempt income).[18]

Distributions of AAA are tax-free to the shareholder to the extent of the shareholder's stock basis.[19]

Note. The legislation did not specify **when** the basis increase resulting from PPP loan forgiveness occurs. Likewise, the treatment for S corporation OAA and AAA adjustments was not provided. If the S corporation had no accumulated earnings and profits, the OAA/AAA distinction is not immediately important. If the owner of the S corporation or partnership had enough tax basis to absorb distributions to the owner, the timing of the basis increase may not affect the individual's 2020 income. Also unclear is whether the adjustment is reported in the year PPP loan proceeds are received or in the year of forgiveness.

Impact on Partners and Partnerships. The adjusted basis of a partner's interest in a partnership is based on the tax basis of property contributed to the partnership.[20] The partner's tax basis is increased by taxable and tax-exempt income and decreased by deductions, losses, and distributions.[21]

A partner is treated as making a cash contribution to the partnership to the extent of its share of the partnership liabilities.[22]

9. *CARES Act,* PL 116-136, §1106(g).
10. SBA IFR, Part III.2.b. revision.
11. *CARES Act,* PL 116-136, §1106(i).
12. IRC §1366(d)(1).
13. IRC §1368(e)(1).
14. Treas. Reg. §1.1368-2(a)(1).
15. IRC §1368(e)(1)(A).
16. *Consolidated Appropriations Act of 2021*, PL 116-260, §276(a), Div. N.
17. IRC §1368(c)(1).
18. The AICPA, in a letter to Treasury dated Mar. 15, 2021, asked Treasury and IRS to issue guidance to clarify that this is the proper treatment of "related expenses" for S corporations and the Treas. Reg. §1.1368-2(a)(3) should be disregarded for this purpose.
19. IRC §1368(b)(1).
20. IRC §705(a).
21. Ibid.
22. IRC §752(a).

Attempted Clarification. The Consolidated Appropriations Act (CAA) of 2021 attempted to clarify the tax treatment of PPP loan forgiveness. The legislation specifies that no deduction is denied, no tax attribute is reduced, and no basis increase is denied by reason of the exclusion of PPP loan forgiveness from gross income.[23] For purposes of determining the tax basis for owners of S corporations and partnerships, the PPP loan forgiveness income is treated as tax-exempt income.[24] **Thus, a shareholder or partner increases their tax basis in the entity based on the shareholder's or partner's share of the tax-exempt income**. Unfortunately, the period in which the borrower paid qualifying expenses with PPP loan funds may not match the period in which the funds were obtained. That mismatch complicates the application of the basis increase.[25]

ERC: BACKGROUND

IRC §3111(a) imposes the 6.2% social security tax (the employer share) on the wages of an employee received with respect to employment.

> **Note.** Employers who pay wages subject to Federal Insurance Contributions Act (FICA) taxes are generally required to quarterly file Form 941, *Employer's QUARTERLY Federal Tax Return*, to report the withheld and paid employment taxes. Farmers file Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees.*[26]

The Coronavirus Aid, Relief, and Economic Stimulus (CARES) Act created the employee retention credit (ERC). The credit is fully refundable against the employer share of social security tax for eligible employers equal to 50% of qualified wages paid in 2020.[27]

The maximum amount of qualified wages taken into account for all 2020 calendar quarters is $10,000 per employee; the maximum credit for wages paid to any employee for 2020 is $5,000.[28]

The ERC was extended for wages paid through June 30, 2021[29] and was later extended through December 31, 2021.[30] In addition, the maximum wages considered per employee was changed to $10,000 per quarter (from $10,000 per year). The credit percentage was also increased for 2021 wages to 70% (from 50%).

> **Note.** Employers can generate a greater ERC for employees earning less than $100,000 per quarter by considering health plan expenses in addition to the gross wage amount.

An **eligible employer** is any employer that carries on a trade or business during calendar year 2020 or 2021, including tax-exempt organizations, that either fully or partially suspends operations during any calendar quarter in 2020 or 2021 due to orders from an appropriate governmental authority limiting commerce, travel, or group meetings (for commercial, social, religious, or other purposes) due to COVID-19; or experiences a significant decline in gross receipts during the calendar quarter.[31]

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23. *Consolidated Appropriations Act of 2021*, PL 116-260, §276(a), Div. N.

24. Ibid.

25. On Mar. 15, 2021, the AICPA sent a letter to IRS recommending that the Treasury and the IRS issue guidance specifying that the period for inclusion of tax-exempt income is when the borrower pays or incurs qualifying expenses during the forgiveness period covered by the loan.

26. Treas. Reg. §31.6011(a)-1(a)(1).

27. *CARES Act,* PL 116-136, §2301.

28. *CARES Act,* PL 116-136, §2301(b).

29. *Consolidated Appropriations Act of 2021*, PL 116-260, §207(a)(1), Div. N.

30. *American Rescue Plan Act of 2021* (ARPA), PL 117-02, §9651.

31. *CARES Act,* PL 116-136, §2301(c)(2).

A significant decline in gross receipts begins with the first calendar quarter in 2020 in which an employer's gross receipts are less than 50% of its gross receipts for the same calendar quarter in 2019.

The significant decline in gross receipts ends with the first calendar quarter that follows the first calendar quarter in which the employer's 2020 quarterly gross receipts are greater than 80% of its gross receipts for the same calendar quarter in 2019.

Note. Some states (such as Illinois) or localities forced full or partial suspension of operations of some commerce for a substantial portion of 2020. Although under a partial suspension of operations, some businesses were able to maintain or increase revenue. These businesses appear to be eligible for the ERC.

Gross Receipts

The test for the decline in gross receipts was changed for 2021 eligibility. Employers are eligible if the gross receipts are less than 80% of the gross receipts of the employer for the comparable 2019 quarter.[32]

Employers may elect to determine gross receipts based on the prior quarter and compared to the corresponding quarter for 2019.[33]

Note. Guidance is necessary as to whether the election applies only to the specific quarter or for that quarter and future quarters.

Example 1. Flying Duck Farm, Inc. (FDFI) is a cash-method farm C corporation with fewer than 500 employees. Through planning, FDFI's quarterly gross receipts in 2021 compared to 2019 are as follows:

- Quarter 1: 35% decrease
- Quarter 2: 15% increase
- Quarter 3: 25% decrease
- Quarter 4: 4% decrease

Quarters 1 and 3 automatically qualify for the ERC because gross receipts declined by more than 20%.

FDFI elects to use the prior quarter for determining Quarter 2 gross receipts. Quarter 2 is treated as having a more than 20% decrease based on results from Quarter 1. FDFI also elects to use the prior quarter for determining Quarter 4 gross receipts based on results from Quarter 3.

Note. In Notice 2021-49, the IRS specified that the determination of whether an employer is an eligible employer based on a decline in gross receipts is made separately for each calendar quarter. This means than an employer is not required to use the alternative calendar quarter election consistently.[34]

Observation. The taxpayer only met the gross receipts test in two quarters but was ERC eligible for the full year.

32. *Consolidated Appropriations Act of 2021*, PL 116-260, §207(d)(1), Div. N.

33. *Consolidated Appropriations Act of 2021*, PL 116-260, §207(d)(2), Div. N.

34. IRS Notice 2021-49, 2021-34 IRB 316.

Gross receipts for employers other than tax-exempt organizations has the same meaning as used in IRC §448(c). Treas. Reg. §1.448-2(c)(2)(iv) refers to Temp. Treas. Reg. §1.448-1T(f)(2)(iv) for the determination of gross receipts. By referring to the temporary regulation for the definition, a permanent regulation makes a 33-year-old temporary regulation provision permanent.

Note. Gross receipts are determined using the taxpayer's accounting method.[35] Most farms report income using the cash method of accounting.

In determining gross receipts, income recognized is adjusted for accounting methods and elections. For example, gross receipts for crop insurance should increase gross receipts in the year recognized (year received or, if elected, the subsequent year). If an election out of the installment sale is made, gross receipts are accelerated into the current year. Gross receipts include any income from investments and from incidental or outside sources. It includes interest income, dividends, rents, etc., regardless of whether the amounts are derived in the ordinary course of operating the farm. Gross receipts are not reduced by the cost of goods sold (COGS). However, gross receipts are reduced by the adjusted basis of capital assets and assets used in the trade or business, such as IRC §1231 assets.

Note. For return preparation purposes, transactions that result in a capital loss or a §1231 loss should be ignored. Only the gain amount (and not the gross sale amount) for gain transactions should be included.

Gross receipts are determined based upon the aggregated group of entities considered as a single employer,[36] which includes related entities over all entity types[37] and affiliated service groups.[38] Transactions between members of the group are eliminated in the determination of gross receipts.[39]

Example 2. John operates his farm as a sole proprietor. He is also a 60% member in another farming operation, Jane, LLC. The sole proprietorship and the LLC are considered a single employer for purposes of the gross receipts test. John's total gross receipts, including interest and dividends reported on Schedule B, *Interest and Ordinary Dividends,* capital gains and §1231 gains (not reduced by losses), and rental income are included with the total gross receipts of Jane, LLC to determine gross receipts.

Note. Transactions between members of the single-employer group are eliminated. Land rent received by John from Jane, LLC is subtracted from total gross receipts.

35. Temp. Treas. Reg. §1.448-1T(f)(2)(iv)(A).

36. IRC §448(c)(2).

37. IRC §52(b).

38. IRC §414(m).

39. Temp. Treas. Reg. §1.448-1T(f)(2)(ii).

Example 3. Use the same facts as **Example 2,** except John is a 40% member in Jane, LLC. John's daughter, Tammy, also owns 40% of Jane, LLC. No other member of Jane, LLC is a related party. Tammy's ownership is not attributed to John because he does not own more than 50% of Jane, LLC. Neither the "at least 80%" test nor the "more than 50%" test of IRC §1563(f)(5) is satisfied. The sole proprietorship and the LLC are not members of a single-employer group.

Note. The IRS published guidance on March 1, 2021 to help determine when operations are considered fully or partially suspended due to a governmental order under the CARES Act FAQs.[40] The FAQs provide several examples. Because farms and food processing plants are considered essential businesses, it is unlikely that the suspension of operations test applies to agriculture. However, an employer with an essential business may be considered to have a full or partial suspension of operations if the business's suppliers are unable to make deliveries of critical goods or materials due to a governmental order.[41] The notice fails to adequately address issues regarding wages paid to related parties.

Caution. For this issue, it is important to note the FAQs have essentially been converted into valid authority by IRS Notice 2021-20. However, in the hierarchy of substantial authority, IRS information or press releases, and notices, announcements, and other administrative pronouncements published by the IRS in the Internal Revenue Bulletin are the **least** authoritative. For more information on substantial authority, see the 2021 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Rulings and Cases.

Note. For more discussion on the ERC, qualified wages and related party issues, see the 2021 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 6: Small Business Issues.

Wages

The definition of qualified wages depends on the average number of full-time employees employed by the eligible employer during 2019.[42] If an eligible employer averaged more than 100 full-time employees in 2019, qualified wages are wages paid to an employee for time that the employee is **not** providing services due to either: (1) a full or partial suspension of operations due to COVID-19, or (2) a significant decline in gross receipts.

If an eligible employer averaged 100 or fewer full-time employees in 2019, qualified wages are wages paid to any employee during a period of economic hardship due to a full or partial suspension of operations due to COVID-19 or a significant decline in gross receipts.

The threshold for determining a large employer was increased to more than 500 full-time employees measured against the 2019 employment.[43]

A full-time employee for ERC purposes is an employee who, with respect to any calendar month in 2019, had an average of at least 30 hours of service per week or 130 hours of service in the month.[44] The number of part-time employees is ignored.

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40. IRS Notice 2021-20, 2021-11 IRB 922; *FAQs: Employee Retention Credit Under the CARES Act, FAQ #28.* Jun. 26, 2021. IRS. [www.irs.gov/newsroom/covid-19-related-employee-retention-credits-determining-what-types-of-governmental-orders-may-be-taken-into-account-for-purposes-of-the-employee-retention-credit-faqs]. Accessed Jul. 14, 2021.

41. IRS Notice 2021-20, 2021-11 IRB 922.

42. *CARES Act,* PL 116-136, §2301(c)(3).

43. *Consolidated Appropriations Act of 2021*, PL 116-260, §207(a)(1), Div. N.

44. IRS Notice 2021-23, 2021-16 IRB 1113.

Qualified wages also include qualified health plan expenses that are properly allocable to such wages.[45] Allocable health plan expenses are calculated in the same manner as calculated for purposes of the Families First Coronavirus Response Act (FFCRA) payroll tax credits.[46]

The same wages may not be taken into account for the ERC and the following credits.

- IRC §41, credit for increasing research activities
- IRC §45A, Indian employment credit
- IRC §45P, employer wage credit for employees who are active-duty members of the uniformed services
- IRC §45S, employer credit for paid family and medical leave
- IRC §51, work opportunity tax credit
- IRC §1396, empowerment zone employment credit

The ERC under the CARES Act can be claimed in one of three ways.

1. On Form 941 or 943
2. Offsetting federal employment tax deposits for the quarter (the employer must account for the reduction in deposits for the quarter)
3. Filing Form 7200, *Advance Payment of Employer Credits Due to COVID-19*

> **Note.** An eligible employer should only file the Form 7200 after it has reduced its remaining federal employment tax deposits for wages paid in the same quarter to zero. If the permitted reduction in deposits does not equal the qualified wages, the eligible employer can file the Form 7200.

Miscellaneous Provisions

An employer receiving the ERC under the CARES Act does not include the credit in gross income for federal income tax purposes. An employer must reduce its aggregate deductions by the amount of its ERC pursuant to the disallowance rule under IRC §280C(a).[47] The reduction is claimed on Schedule F, *Profit or Loss from Farming,* the labor hired line item **for the same year** as the ERC is computed.

> **Note.** Similarly, other credits such as the §41 research credit and the §51 work opportunity tax credit reduce wage deductions.

Form W-2 wages are properly allocable to qualified business income (QBI) if the associated wage expense is taken into account in computing QBI under Treas. Reg. §1.199A-3.[48] ERC does not reduce the amount of qualified wages for QBI calculations. The IRS has not addressed the effect of disallowing expenses when the issue was raised after IRS Notice 2020-32.[49] Apparently, the IRS and the Treasury are exercising latitude in the interpretation of various statutes to make them function as intended.

45. *CARES Act,* PL 116-136, §2301(c)(3)(C).
46. *Families First Coronavirus Response Act,* PL 116-127.
47. *CARES Act,* PL 116-136, §2301(e).
48. Treas. Reg. §1.199A-2(b)(4).
49. IRS Notice 2020-32, 2020-21 IRB 837.

An employer may receive a PPP loan and qualify for the ERC. However, a taxpayer may **not** use the same wages for both provisions.[50] Payroll costs considered for the ERC are not qualified payroll costs for the PPP forgiveness computation.

Note. Under this provision, claiming the wages and health insurance costs for the ERC controls the qualification of the wages for the PPP. Although these payroll costs may have been claimed on the PPP forgiveness application, claiming an ERC on the same wages should cause reduction in qualified payroll costs for PPP.

Practitioner Planning Tip

Farm employers that received both a PPP and ERC should, to the maximum extent possible, use nonpayroll costs (rent, mortgage interest, utilities, etc.) in the computation for PPP loan forgiveness. This reserves more payroll costs for the beneficial ERC.

CANCELLATION OF DEBT INCOME

OVERVIEW

The general rule is that discharge of indebtedness produces ordinary income—known as cancellation of debt income (CODI).[51] However, there are exceptions to the general rule, which are shown in Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*. One of those exceptions concerns a debtor that is "insolvent" but not in bankruptcy. An insolvent debtor that is not in bankruptcy does not have CODI to report, although may have tax attributes to adjust. In 2017, the U.S. Tax Court clarified how insolvency is measured. Unfortunately, the IRS recently voiced its disagreement with the Tax Court's 2017 opinion.

Form **982**
(Rev. March 2018)
Department of the Treasury
Internal Revenue Service

Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)
► Attach this form to your income tax return.
► Go to *www.irs.gov/Form982* for instructions and the latest information.

OMB No. 1545-0046
Attachment Sequence No. **94**

Name shown on return | **Identifying number**

Part I **General Information** (see instructions)

1 Amount excluded is due to (check applicable box(es)):
a Discharge of indebtedness in a title 11 case ☐
b Discharge of indebtedness to the extent insolvent (not in a title 11 case) ☐
c Discharge of qualified farm indebtedness ☐
d Discharge of qualified real property business indebtedness ☐
e Discharge of qualified principal residence indebtedness (**Caution:** See instructions before checking this box if debt was discharged after 2017.) ☐
2 Total amount of discharged indebtedness excluded from gross income **2**
3 Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property? ☐ Yes ☐ No

Reduction of Tax Attributes. You must attach a description of any transactions resulting in the reduction in

50. *Consolidated Appropriations Act of 2021*, PL 116-260, §§206(c) and (e), Div. N; §§206(c) and (e), retroactive to the enactment date of the *CARES Act.*

51. IRC §61(a)(12).

An important part of debt resolution is the income tax consequences to the debtor. There are two major categories of income tax consequences.

1. Gain or loss if property is transferred to the lender in satisfaction of indebtedness
2. Possible CODI to the extent debt discharged exceeds the fair market value (FMV) of property given up by the debtor

Recourse Debt

The handling of discharge of indebtedness income depends upon whether the debt was recourse or nonrecourse. With recourse debt, the collateral stands as security on the obligation. If the collateral is insufficient, the debtor is personally liable on the obligation, and the debtor's nonexempt assets are reachable to satisfy any deficiency. The bulk of farm and ranch debt is recourse debt.

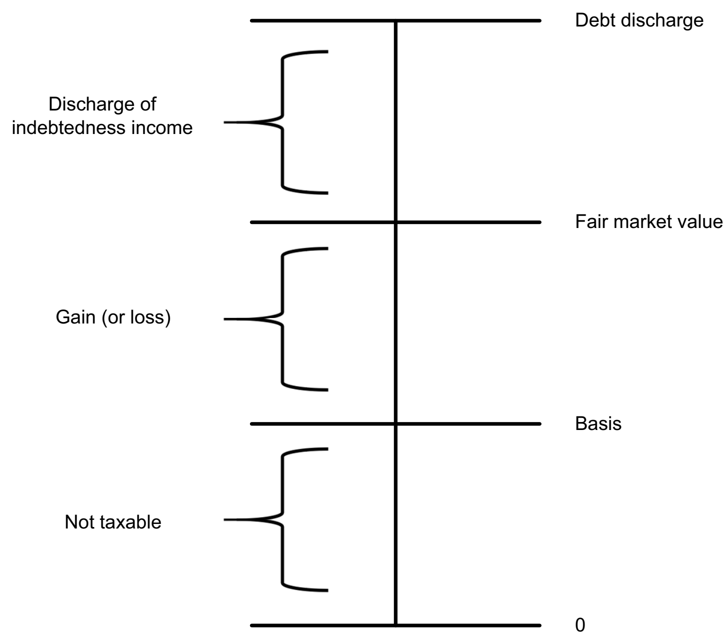
For recourse debt, when property is given up by the debtor, the income tax consequences involve a 2-step process.

Step 1. It is as if the property is sold to the creditor and the sale proceeds are applied on the debt. To the extent of the income tax basis of the property, there is no gain or loss. The difference between FMV and the income tax basis is gain or loss. There is no relief from gain — even if the taxpayer is insolvent.

Step 2. If the indebtedness forgiven exceeds the property's FMV, the difference is considered discharge of indebtedness income.

The following figure illustrates the income tax treatment of discharge of indebtedness income.[52]

Income Tax Treatment of Discharge of Indebtedness Income



[52] McEowen, Roger A. *Principles of Agricultural Law*, Chapter 5, Sec. 5.10[2], Figure 2, Release 49, Aug. 2021. Used with permission.

Nonrecourse Debt

For nonrecourse debt, the collateral stands as security on the obligation. However, if the collateral is worth less than the balance on the debt, the debtor does not bear personal liability on the obligation. The creditor must rely solely on the collateral in the event of default. Very little farm and ranch debt is nonrecourse, except perhaps for some installment land contracts. Commodity Credit Corporation loans, to the extent the debtor may pay off the loan with a sufficient amount of an eligible commodity having a price support value equal to the outstanding value of the loan (or less than the value of the loan in the case of a marketing assistance loan), are also nonrecourse debt.

Handling nonrecourse debt involves a simpler 1-step process.[53] FMV is ignored, and the entire difference between the income tax basis of any property involved (and transferred to the creditor) and the amount of debt discharged is gain (or loss). There is no CODI.

EXCEPTIONS

There are several relief provisions that a debtor may be able to use to avoid the general rule that CODI constitutes income.

Bankruptcy[54]

A debtor in bankruptcy does not report CODI as income. However, the debtor must reduce tax attributes (including operating losses and business tax credits carried forward) and reduce the income tax basis of their property. Losses are reduced dollar for dollar. Credits are reduced $1 of credit for $3 of CODI. To preserve net operating losses (NOLs) and tax credit carryovers, a debtor may elect to reduce the basis of depreciable property before reducing other tax attributes.

Real Property Business Debt[55]

Taxpayers, other than C corporations, can elect to exclude from gross income amounts realized from the discharge of **qualified real property business indebtedness**. The term qualified real property business indebtedness means certain debt which was incurred or assumed by the taxpayer in connection with real property used in a trade or business. The term specifically **excludes qualified farm indebtedness**, which is covered under a separate Code section. Taxpayers who make the election to exclude CODI from income under this provision must reduce the income tax basis of the property securing the debt.

Solvent Farmers Not in Bankruptcy[56]

For all debtors other than farmers, once solvency is reached and debts are discharged, there is CODI. For solvent farm debtors, there is special treatment. The discharge of indebtedness arising from an agreement between a person engaged in the trade or business of farming and a qualified person to discharge qualified farm indebtedness is eligible for special treatment. There is a specific procedure available to the debtor that is used for reducing tax attributes and reducing the basis of property. This results in a reduction of taxable CODI.

A **qualified person** is someone who is actively and regularly engaged in the business of lending money and who is not somehow related to or connected with the debtor. **Qualified farm indebtedness** means indebtedness incurred directly in connection with the operation by the taxpayer of the trade or business of farming. To qualify, 50% or more of the average annual gross receipts of the taxpayer for the three preceding taxable years (in the aggregate) must be attributable to the trade or business of farming. In many instances, nonfarm income makes qualifying for the solvent farm debtor rule difficult.

Note. A cash-rent landlord is typically not engaged in the trade or business of farming. Therefore, the discharge of indebtedness is not considered discharge of qualified farm indebtedness.[57]

53. See *Comm'r v. Tufts,* 461 U.S. 300 (1983).

54. IRC §108(a)(1)(A).

55. IRC §108(a)(1)(D).

56. IRC §108.

57. See *Lawinger v. Comm'r,* 103 TC 428 (1994).

If the requirements are met, a solvent farm debtor first reduces tax attributes in the following order.

1. NOL of the taxable year and any carryover losses to that year
2. General business credits (including investment tax credits carried over to that year)
3. Minimum tax credit
4. Capital losses for the year and capital losses carried over to that year
5. Passive activity loss and credit carryovers
6. Foreign tax credits

As discussed previously, losses reduce CODI dollar for dollar. Credits are reduced $1 of credit for $3 of CODI.

After the reduction of tax attributes, solvent farm debtors reduce the income tax basis of property used in a trade or business or held for the production of income in the following order.

1. Depreciable property
2. Land used or held for use in the trade or business of farming
3. Other qualified property

Note. An election can be made to reduce the basis of depreciable property first, before reducing the tax attributes. This may help preserve the tax attributes for later use.

After tax attributes and property basis are reduced, if an amount of discharge of indebtedness remains, the remainder is income.

Purchase Price Adjustment[58]

For solvent taxpayers who are not in bankruptcy, any negotiated reduction in the purchaser's debt payable to the seller of an asset does not have to be reported as CODI. The debt forgiveness is treated as a reduction of the selling price. To be eligible, the debt reduction must involve the original buyer and the original seller.

Insolvent Debtors[59]

Debtors who are insolvent but not in bankruptcy do not have CODI. Insolvent debtors must reduce tax attributes and reduce the income tax basis of property. It is handled in a similar manner as debtors in bankruptcy. However, the amount of income from discharge of indebtedness that can be excluded from income is limited to the extent of the debtor's insolvency. If the amount of debt discharged exceeds the amount of the insolvency, income is triggered to the amount of solvency. Consequently, for the rule of insolvent taxpayers to apply, the taxpayer must be insolvent both before and after the transfer of property and reduction of indebtedness.

DETERMINING INSOLVENCY

The determination of the debtor's insolvency is made immediately before the discharge of indebtedness. **Insolvency** is defined as the excess of liabilities over the FMV of the debtor's assets.[60] Both tangible and intangible assets are included in the calculation. Both recourse and nonrecourse liabilities are included in the calculation; however, contingent liabilities are not. The separate assets of the debtor's spouse are not included in determining the extent of the debtor's insolvency.

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58. IRC §108(e)(5).
59. IRC §108(a)(1)(B).
60. IRC §108(d)(3).

Historically, the courts have held that property exempt from creditors under state law is not included in the insolvency calculation. However, the IRS ruled in 1999 that property exempt from creditors under state law is included in the insolvency calculation.[61] In 2001, in *Carlson v. Comm'r*,[62] the Tax Court agreed with the IRS's position. It held that a commercial fishing license was an asset because the license could be used, in combination with other assets, to immediately pay the income tax on cancelled debt income.

Recent Tax Court Clarification

In *Schieber v. Comm'r*,[63] the petitioner retired from a police force in 2005 and began receiving monthly distributions from his pension plan. The plan withheld federal income tax from the payments. The plan specified that the petitioner could not convert his interest in the plan into a lump-sum cash amount, assign the interest, sell the interest, borrow against the interest, or borrow from the plan. Upon the petitioner's death, his surviving wife would receive payments for her life. In 2009, GMAC Mortgage cancelled approximately $450,000 of the petitioner's mortgage debt that was secured by some of the petitioner's nonresidential real estate. The petitioner was not in bankruptcy in 2009. The cancelled debt included $30,076 of interest. The petitioner excluded the forgiven interest from income because he had not deducted it on his Form 1040, *U.S. Individual Income Tax Return*.[64] That provision specifies that "no income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction."

While the IRS conceded this point concerning the interest exclusion, the IRS claimed that the petitioner's $418,596 principal that was cancelled should be included in income. The petitioner claimed that the pension plan should not be considered an asset for purposes of the insolvency computation of IRC §108(d)(3). Under that provision a taxpayer may exclude cancelled debt from income to the extent of the taxpayer's insolvency, defined as the extent to which the taxpayer's liabilities exceed the FMV of the taxpayer's assets.

IRC §108(d)(3) does not define the term assets. As discussed previously, in *Carlson v. Comm'r*,[65] the full Tax Court determined that the value of an exempt asset could be included in the insolvency calculation if it gives the taxpayer "the ability to pay an immediate tax on income" from the cancelled debt. In *Schieber,* the petitioner claimed that he could not access the pension funds by its terms. The IRS did not challenge that point, claiming that the point was irrelevant. Instead, the IRS claimed that the petitioner's right to receive monthly payments caused the plan to be considered an asset. The Tax Court disagreed, clarifying that its prior decision in *Carlson* only extended to assets that gave the taxpayer the "ability to pay an immediate tax on income" from the cancelled debt, not the ability to pay the tax gradually over time.

Note. The IRS disagrees with the Tax Court's opinion in *Schieber.*[66]

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61. Ltr. Rul. 9932013 (May 4, 1999), revoking Ltr. Rul. 9125010 (Mar. 10, 1991); TAM 9935002 (May 3, 1999).

62. *Carlson v. Comm'r,* 116 TC 87 (2001).

63. *Schieber v. Comm'r,* TC Memo 2017-32 (Feb. 9, 2017).

64. See IRC §108(e)(2).

65. *Carlson v. Comm'r,* 116 TC 87 (2001).

66. AOD 2021-1 (Apr. 12, 2021).

LOAN FORGIVENESS: ARPA[67]

Section 1005 of the American Rescue Plan Act of 2021 (ARPA) directs the U.S. Secretary of Agriculture to pay up to 120% of the outstanding debt in existence as of January 1, 2021, of a "socially disadvantaged farmer or rancher."[68] The payment is to either be a direct pay-off of the borrower's loan or be paid to the borrower with respect to any of the borrower's United States Department of Agriculture (USDA) direct farm loans and any USDA-guaranteed farm loan.[69]

On its website,[70] the USDA stated that, "Eligible Direct Loan borrowers will begin receiving debt relief letters from the Farm Service Agency (FSA) in the mail on a rolling basis, beginning the week of May 24. . . After reviewing closely, eligible borrowers should sign the letter when they receive it and return to FSA." It advises that, in June 2021, the FSA will begin to process signed letters for payments, and "about three weeks after a signed letter is received, socially disadvantaged borrowers who qualify will have their eligible loan balances paid and receive a payment of 20% of their total qualified debt by direct deposit, which may be used for tax liabilities and other fees associated with payment of the debt."[71]

In *Foust, et al. v. Vilsack,*[72] the court entered a universal temporary restraining order barring the USDA from forgiving any loans pursuant to ARPA §1005 until the court rules on the plaintiffs' motion for a preliminary injunction. The court noted that the plaintiffs, 12 white farmers from nine states, would suffer irreparable harm without the issuance of the restraining order; did not have adequate traditional legal remedies; and had likelihood of success on the merits.

The court concluded that the USDA lacked a compelling interest for the racial classifications of the loan forgiveness program and failed to target any specific episode of past or present discrimination. The court also determined that the USDA had no evidence of intentional discrimination by the USDA in the implementation of recent agricultural subsidies and pandemic relief efforts. As such, the USDA failed to establish that it had a compelling interest in remedying the effects of past and present discrimination through the distribution of benefits based on racial classifications.

The court concluded that the plaintiffs were likely to succeed on the merits of their claim that the USDA's use of race-based criteria in the administration of the program violates their right to equal protection under the law. The court further determined that if it did not issue the injunction, the USDA would spend the allocated funds for the loan forgiveness program and forgive the loans of minority farmers while the case is pending and will have no incentive to provide similar relief on an equitable basis to others. The court stated, "Plaintiffs are excluded from the program based on their race and are thus experiencing discrimination at the hands of their government." Accordingly, the court held that the plaintiffs had established a strong likelihood that §1005 of the ARPA is unconstitutional and that the public interest favored the issuance of a temporary restraining order.

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67. *American Rescue Plan Act of 2021,* PL 117-2.

68. *American Rescue Plan Act of 2021,* PL 117-2, §1005(a)(2). A "socially disadvantaged farmer or rancher" is defined as a person that is a member of a "socially disadvantaged group" which is defined, in turn, as a group whose members have been subjected to racial or ethnic prejudice because of their identity as members of a group without regard to their individual qualities; *American Rescue Plan Act,* PL 117-2, §1005(b)(3), referencing 7 USC 2279(a). In short, the loan forgiveness program is based entirely on the race of the farm or ranch borrower.

69. *American Rescue Plan Act of 2021,* PL 117-2, §§1005(a)(2)(A)–(B). Also included is a Commodity Credit Corporation Farm Storage Facility Loan.

70. *American Rescue Debt Plan Payments.* USDA. [www.farmers.gov/americanrescueplan] Accessed on Jul. 14, 2021.

71. Ibid. $3.8 billion was allocated to the program.

72. *Foust, et al. v. Vilsack*, No. 21-C-548 (E.D. Wisc. Jun. 10, 2021).

Note. On July 6, 2021, the *Foust* court stayed the plaintiffs' motion for a preliminary injunction and dissolved the temporary restraining order, but only because a federal district court in Florida had issued a detailed opinion on a much more complete record granting a different farmer's motion for the same preliminary nationwide injunction against enforcement of the provision based on the same equal-protection guarantee as was at issue in *Foust.*[73] As such, the *Foust* court was no longer convinced that the plaintiffs in *Foust* could establish irreparable harm. The *Foust* court noted that the stay could be lifted if the injunction issued by the *Wynn* court is vacated or materially altered.

Additionally, on July 8, 2021, another federal district court granted an identical nationwide preliminary injunction against disbursement of funds under Section 1005 of ARPA.[74] On August 2, 2021, the court denied the USDA's request to stay the proceedings pending the resolution of a related class action lawsuit on the issue.[75]

Observation. This program, if implemented, would require a review of loan documents, asset valuations, and debt amounts to determine to what extent taxable gain or CODI is generated from these transactions.

NOLs

TCJA

For an NOL arising in a tax year beginning after 2017, the Tax Cuts and Jobs Act (TCJA) limited its deductibility to 80% of taxable income (computed without the NOL deduction). Under the TCJA, no NOL carryback was allowed unless the NOL related to the taxpayer's farming business.[76] A farming NOL could be carried back two years, but a taxpayer could make an irrevocable election to waive the carryback.[77] Under the TCJA, post-2017 NOLs do not expire.

CARES ACT

The CARES Act suspended the 80% limitation for NOLs through the 2020 tax year.[78] The suspension applies to all NOLs, farm or nonfarm, arising in tax years beginning in 2018–2020.[79] The CARES Act also removed the 2-year carryback option for farm NOLs and replaced it with a 5-year carryback for all NOLs arising in a tax year beginning after 2017 and before 2021.[80] Under the carryback provision, an NOL could be carried back to each of the five tax years preceding the tax year of the loss (unless the taxpayer elected to waive the carryback). That created an issue — some farmers had already carried back an NOL for the 2-year period that the TCJA allowed.

Note. For a full discussion of NOLs in the farm context and the pre-TCJA, TCJA and CARES Act rules, see the 2020 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 5: Agricultural Issues and Rural Investments.

73. *Wynn v. Vilsack,* No. 3:21-cv-514-MMH-JRK, 2021 US Dist. LEXIS 117402 (M.D. Fla. Jun. 23, 2021).

74. *Holman v. Vilsack,* No. 21-1085-STA-jay,2021 US Dist. LEXIS 127334 (W.D. TN Jul. 8, 2021).

75. *Holman v. Vilsack,* No. 1:21-cv-1085-STA-jay, 2021 US Dist. LEXIS 143903 (W.D. Tenn. Aug. 2, 2021).

76. IRC §172(b)(1)(B)(ii).

77. IRC §§172(b)(1)(B)(iv) and (b)(3). The 80% provision also applied to farm NOLs that were carried back for NOLs generated in years beginning after 2017.

78. IRC §172(a)(1). The NOL is determined without regard to the 20% QBID; IRC §§172(a)(2)(B)(ii)(I) and 172(d)(8).

79. More specifically, §2303(a) of the CARES Act amended IRC §172(a) to provide that the 80% limitation applies only to NOLs arising in tax years beginning after 2017 that are deducted in tax years beginning after 2020.

80. *CARES Act,* PL 116-136, §2303(b), amending IRC §172(b)(1).

CRTRA

As part of the CAA of 2021, the COVID-Related Tax Relief Act of 2020 (CRTRA)[81] amended the CARES Act to allow taxpayers to elect to disregard the CARES Act provisions for farming NOLs. This is commonly referred to as the **CRTRA election.** Under the CRTRA election, farmers that had elected the 2-year carryback under the TCJA can elect to retain that carryback (limited to 80% of the pre-NOL taxable income of the carryback year) rather than claim the 5-year carryback under the CARES Act.[82] In addition, farmers that previously waived an election to carryback an NOL can revoke the carryback waiver.

The CRTRA specifies what occurs if a taxpayer with a farm NOL filed a federal income tax return before December 27, 2020, that disregards the CARES Act amendments to the TCJA. The taxpayer is treated as having made a **deemed election.** This is the result unless the taxpayer amended the return to reflect the CARES Act amendments by the due date (including extensions of time) for filing the return for the first tax year ending after December 27, 2020.[83] For calendar-year taxpayers, the latest date was October 15, 2021. Consequently, the taxpayer is deemed to have elected to utilize the 2-year carryback provision of the TCJA instead of the 5-year carryback.

IRS Guidance

On June 30, 2021, the IRS issued Rev. Proc. 2021-14.[84] This provides guidance for taxpayers with an NOL for a tax year beginning in 2018–2020, when all or a portion of it consists of a farming loss. The guidance details how the taxpayer can elect to not apply certain NOL rules of the CARES Act, and how the CRTRA election can be revoked. Rev. Proc. 2021-14 became effective on June 30, 2021.

Affirmative Election. The revenue procedure specifies that a taxpayer with a farming NOL may make an affirmative CRTRA election to disregard the CARES Act–NOL amendments if the farming NOL arose in any tax year beginning in 2018–2020.

This process is not available to taxpayers making a deemed election.

An affirmative election allows the farm taxpayer to carryback a 2018–2020 farm NOL two years instead of five years. To make an affirmative election, the taxpayer must satisfy **all** the following conditions.

- The taxpayer must make the election on a statement by the due date, including extensions of time, for filing the taxpayer's federal income tax return for the taxpayer's first tax year ending after December 27, 2020.[85]
- The top of the statement must state: "The taxpayer elects under §2303(e)(1) of the CARES Act and Revenue Procedure 2021-14 to disregard the amendments made by §2303(a) of the CARES Act for taxable years beginning in 2018, 2019, and 2020, and the amendments made by §2303(b) of the CARES Act that would otherwise apply to any NOL arising in any taxable year beginning in 2018, 2019, or 2020. The taxpayer incurred a farming loss NOL, as defined in section 1.01 of Rev. Proc. 2021-14 in [list each applicable taxable year beginning in 2018, 2019, or 2020]."[86]
- The taxpayer attaches a copy of the statement to any original or amended federal income tax return or application for tentative refund on which the taxpayer claims a deduction attributable to a 2-year NOL carryback pursuant to the affirmative election.

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81. *Consolidated Appropriations Act of 2021,* PL 116-260, Subtitle B of Div. N. Division N contains the CRTRA.
82. *Consolidated Appropriations Act of 2021*, PL 116-260, Div. N, §281(a).
83. *Consolidated Appropriations Act of 2021*, PL 116-260, Div. N, amending *CARES Act,* §2303(e)(1)(B)(ii)(II).
84. Rev. Proc. 2021-14, 2021-30 IRB 158.
85. For calendar-year individuals and C corporations, the date is Oct. 15, 2021.
86. This is an all-or-nothing election. The taxpayer must choose either the 2-year farm NOL carryback provision for all loss years within 2018–2020, or not.

For taxpayers that follow the revenue procedure and make an affirmative election, the revenue procedure specifies that the 80% limitation on NOLs applies. This determines the amount of an NOL deduction for tax years beginning in 2018–2020, to the extent the deduction is attributable to NOLs arising in tax years beginning after 2017. In addition, the CARES Act carryback provisions do not apply for NOLs arising in tax years beginning in 2018–2020.

Deemed Election Procedure. In §3.02 of the revenue procedure, the IRS sets forth the procedure for a taxpayer to follow to **not be treated** as having made a deemed election. For taxpayers that made a deemed election under the CARES Act, the election applies unless the taxpayer amends the return for the tax year the deemed election applies to reflect the CARES Act amendments by the due date specified in the revenue procedure.

For taxpayers that made a deemed election for a 2-year carryback claim under the CARES Act, which was subsequently rejected by the IRS, Rev. Proc. 2021-14 establishes the steps to pursue those claims. Those steps require the taxpayer to submit complete copies of the rejected applications or claims, together with income tax returns for the loss year(s). The top margin of the first page of a complete copy of each application or claim should include, "Deemed Election under Section 3.02(2) of Rev. Proc. 2021-14." The revenue procedure states that resubmission of previously rejected claims should be sent by the revenue procedure due date.[87]

Note. The taxpayer is not treated as having made a deemed election if the taxpayer subsequently files an amended return or an application for tentative refund by the due date of the revenue procedure.

Guidance is provided for a taxpayer that elected not to have the 2-year carryback period apply to a farming NOL incurred in a tax year beginning in 2018 or 2019.

The revenue procedure specifies that the taxpayer may revoke the election if the taxpayer made the election before December 27, 2020.

The revocation must be made on an amended return by the date that is three years after the due date, including extensions of time, for filing the return for the tax year the farming NOL was incurred.[88]

Previously, the IRS stated in an FAQ that the waiver election could not be revoked.

Note. A statement must be attached to the return to revoke the prior election to waive the carryback period. The statement must read as follows: "Pursuant to section 4.01 of Rev. Proc. 2021-14 the taxpayer is revoking a prior IRC §172(b)(1)(B)(iv) or IRC §172(b)(3) election to not have the 2-year carryback period provided by IRC §172(b)(1)(B)(i) apply to the farm NOL, as defined in section 1.01 of Rev. Proc. 2021-14, incurred in the taxable year."[89]

87. "Should" likely means "must."

88. If the NOL is not fully absorbed in the 5-year earlier carryback year, the balance carries forward to the fourth year back and subsequent years in the carryback period until it is fully absorbed. The taxpayer may also amend the returns for the years in the 5-year carryback period, if needed, to utilize the benefits of IRC §1301 (farm income averaging).

89. Electing to not have the 2-year carryback apply will allow the NOL to be carried back five years.

Area of Uncertainty. What remains unclear after the issuance of Rev. Proc. 2021-14 is whether the affirmative CRTRA election can be made to use the 2-year carryback if a farmer had previously waived the 5-year carryback. It appears the opportunity to revoke does not apply to the waiver of the 5-year NOL carryback contained in IRC §172(b)(3).

Example 4. Hamilton Beech is a calendar-year farmer. He sustained a farming NOL in 2019. However, 2017 was a good year financially and Hamilton wanted to apply the TCJA 2-year carryback provision so that he could use the 2019 NOL to offset the impact of the higher tax brackets on his 2017 taxable income. Unfortunately, the CARES Act (enacted into law on March 27, 2020) eliminated the 2-year carryback provision, leaving Hamilton with the choice of either carrying the 2019 NOL to 2014 or electing to forgo the 5-year carryback.

Hamilton's 2014 was a low-income year. Hamilton elected to waive the 5-year NOL carryback provision on his 2019 return he filed on April 15, 2020 (after CARES but before CAA). He attached a statement referencing IRC §172(b)(3) (instead of IRC §172(b)(1)(B)(iv)).

Because Hamilton filed his 2019 return after March 27, 2020, and before December 27, 2020, uncertainty exists concerning his ability to make an **affirmative election** under the revenue procedure to disregard the CARES Act 5-year NOL carryback provision. If an affirmative election could be made, he would be able to use the 2-year carryback rule to offset his higher income in 2017 instead of the 5-year carryback to 2014. Hamilton would now be able to amend his 2019 return, citing Rev. Proc. 2021-14, §3.01 stating he has met the conditions of §3.01(2).

Note. The taxpayer must also attach a statement to the top of an amended return for the loss year, stating: "Pursuant to section 4.01 of Rev. Proc. 2021-14, the taxpayer is revoking a prior IRC §172(b)(1)(B)(iv) or IRC §172(b)(3) election not to have the 2-year carryback period provided by IRC §172(b)(1)(B)(i) apply to the Farming Loss NOL, as defined in section 1.01 of Rev. Proc. 2021-14, incurred in the taxable year."

Mixed NOLs. If a taxpayer has an NOL that is a mixture of farm and nonfarm activities, the portion of the NOL that is attributable to the farming activity may be carried back either two or five years consistent with the guidance of the revenue procedure. The nonfarm portion of the NOL may not be carried back two years because only a 5-year carryback applies. Also, the election to waive the carryback period is all-or-nothing. **It is not possible to separately waive a farm NOL carryback from a nonfarm NOL.**

Observation. Treas. Reg. §301.9100-2(b) allows the amendment for regulatory or statutory elections up to six months from the due date. Regardless, October 15, 2021 is the deadline for a calendar-year 2020 individual or C corporation return.

It is too late to waive the NOL carryback for 2019. The new revenue procedure provides for revoking the waiver election but does not mention anything about making a late waiver election. Waiving the NOL carryback for 2019 without any specific allowance for it is an uncertain position.

FINAL QBI REGULATIONS: AGRICULTURAL/HORTICULTURAL COOPERATIVES

In early 2021, the Treasury issued final regulations providing guidance to agricultural/horticultural cooperatives and patrons on the IRC §§199A(a) and 199A(c) deduction for QBI. The final regulations make several changes to the proposed regulations and are important to patrons of agricultural cooperatives and return preparers.

BACKGROUND

The CAA of 2018 contained a provision modifying §199A that was included in the TCJA enacted in late 2017. IRC §199A created a 20% QBI deduction (QBID) for sole proprietorships and pass-through businesses. However, the provision created a tax advantage for sellers of agricultural products sold to agricultural cooperatives. Before the technical correction, those sales generated a tax deduction from gross sales for the seller. However, if those same agricultural goods were sold to a company that was not an agricultural cooperative, the deduction could only be taken from net business income. That tax advantage for sales to cooperatives was deemed a drafting error and was subsequently modified.

The modified provision removed the TCJA's QBID provision for agricultural cooperatives and replaced it with the former (pre-2018) IRC §199 domestic production activities deduction (DPAD) for cooperatives. In addition, the TCJA provision creating a 20% deduction for patronage dividends was eliminated. The modified language also limited the deduction to 20% of farmers' net income, excluding capital gains.

2018 MODIFICATION: NEW IRC §199A(g)

As noted, the CAA removed the QBID for agricultural/horticultural cooperatives.[90] In its place, the former DPAD provision is restored in a similar manner for such cooperatives. Thus, an agricultural cooperative can claim a deduction from taxable income that is equal to 9% of the lesser of the cooperative's qualified production activities income (QPAI) or taxable income. This is determined without regard to the cooperative's §199A(g) deduction and any deduction allowable under §§1382(b) and (c) (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions) for the taxable year.[91]

> **Note.** The cooperative's deduction is designed to be equivalent to the former DPAD of IRC §199.

For a cooperative, QPAI is the domestic production gross receipts (DPGR) of the cooperative in excess of COGS and other expenses, losses, or deductions properly allocable to DPGR.[92] The cost of acquiring product from patrons is not a COGS to cooperatives. Instead, these amounts are treated as advances of patronage, reported on Box 2 of Form 1099-PATR, *Taxable Distributions Received from Cooperatives*. Taxable income of cooperatives is determined without regard to patronage dividends, per-unit retain allocations and nonpatronage distributions.[93] The deduction cannot exceed 50% of the Form W-2 wages of the cooperative for the year.[94]

The amount of the deduction for a taxable year is limited to 50% of the W-2 wages paid by the cooperative during the calendar year that ends in such taxable year.

> **Note.** The 50% of W-2 wages limitation is likely the limitation that applies.

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90. *Consolidated Appropriations Act of 2018*. PL 115-141, §101, Div. T, adding IRC §199A(g).

91. A cooperative which is a partner in a partnership computes the 9% deduction for its share of qualified items of income, gain, deduction, and loss, including Form W-2 wages and investment in qualified property. IRC §199A(g)(2)(A).

92. IRC §199A(g)(3).

93. IRC §199A(g)(1)(C).

94. IRC §199A(g)(1)(B).

For this purpose, Form W-2 wages are determined in the same manner as under the other provisions of §199A (which was not repealed as applied to noncooperatives), except that wages do not include any amount that is not properly allocable to DPGR. A cooperative's DPAD is reduced by any amount passed through to patrons.

An amount passed through to a patron is accomplished by the cooperative issuing a written notice of allocation mailed during the IRC §1382 payment period.[95] The notice must be mailed by the cooperative to the taxpayer no later than the 15th day of the ninth month following the close of the cooperative's tax year.[96] A patron uses the information that the cooperative reports to determine the patron's QBID. If the information is not received on or before the Form 1099-PATR due date, no distributions from the cooperative will count towards the patron's QBI if the lack of reporting occurs after June 19, 2019.[97]

> **Note.** The Preamble to the Final Regulations (discussed later) specify that the recipient is responsible for determining eligibility for the passed-through amount.[98] Cooperatives and patrons may not contractually agree that a payment is not a qualified payment.[99]

The deduction is allocated in the same manner that cooperative income is allocated to patrons. Eligible taxpayers receiving a passed-through amount may include the deduction in computing taxable income without regard to wage expense.[100]

The 2020 Form 1099-PATR was modified from prior years to report the following.

- **Box 6:** §199A(g) deduction
- **Box 7:** Qualified payments (§199A(b)(7))
- **Box 8:** §199A(a) qualified items
- **Box 9:** §199A(a) specified service trade or business (SSTB) items

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		1 Patronage dividends $ 2 Nonpatronage distributions $ 3 Per-unit retain allocations $	OMB No. 1545-0118 2021 Form 1099-PATR	Taxable Distributions Received From Cooperatives
PAYER'S TIN	RECIPIENT'S TIN	**4 Federal income tax withheld** $	5 Redeemed nonqualified notices $	**Copy B For Recipient**
RECIPIENT'S name		6 Section 199A(g) deduction $	7 Qualified payments (Section 199A(b)(7)) $	This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address (including apt. no.)		8 Section 199A(a) qual. items $	9 Section 199A(a) SSTB items $	
City or town, state or province, country, and ZIP or foreign postal code		10 Investment credit $	11 Work opportunity credit $	
Account number (see instructions)		12 Other credits and deductions $	13 Specified Coop ☐	

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

95. IRC §199A(g)(2)(A); Treas. Reg. §1.199A-8(d)(3).
96. Treas. Reg. §1.199A-8(d)(3).
97. Prop. Treas. Reg. §1.199A-7(c)(3); Prop. Treas. Reg. §1.199A-7(d)(3).
98. TD 9947, Preamble, II. F.
99. TD 9947, Preamble, II. H.
100. Ibid. The only limitation at the patron level is taxable income determined without regard to the deduction, but after accounting for the patron's other deductions under IRC §199A(a). IRC §199A(g)(2)(B). But it is reduced by the lesser of 9% of QBI allocable to patronage dividends and per-unit retains received by the patron or 50% of the Form W-2 wages with respect to the business. IRC §199A(b)(7).

Under the modified provision, the definition of a **specified agricultural or horticultural cooperative**[101] is limited to organizations to which part I of subchapter T applies that either:

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

The modification specifies that Treas. Reg. §1.199-6(f) is to apply such that agricultural or horticultural products also include fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production that are manufactured, produced, grown, or extracted by the cooperative.[102]

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

Impact on Patrons

Under the new language, an eligible patron that receives a qualified payment from a specified agricultural or horticultural cooperative can claim a deduction in the tax year of receipt. The amount of the deduction is equal to the portion of the cooperative's deduction for QPAI that is:[103]

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

> **Note.** The cooperative's §199A(g) deduction is allocated among its patrons on the basis of the quantity or value of business done with or for the patron by the cooperative.

The patron's deduction may not exceed the patron's taxable income for the taxable year. This is determined without regard to the deduction and after accounting for the patron's other deductions under §199A(a).

Qualified Payment

A qualified payment is any amount that meets **all three** of the following tests.[104]

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

An eligible patron[105] cannot be a corporation and cannot be another agricultural cooperative. In addition, a cooperative cannot reduce its income under §1382 for any deduction allowable to its patrons by virtue of §199A(g). Thus, the cooperative must reduce its deductions that are allowed for certain payments to its patrons in an amount equal to the §199A(g) deduction allocated to its patrons.

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101. *Consolidated Appropriations Act of 2018,* PL 115-141, §101(a)(1), Div. T.
102. Ibid.
103. IRC §199A(g)(2)(A)(i); Treas. Reg. §1.199A-7(g).
104. IRC §§199A(g)(2)(E)(i–iii).
105. IRC §199A(g)(2)(D).

AGRICULTURAL COOPERATIVES AND PATRONS AFTER THE CAA

With the technical correction to §199A, changes impacting farmers include the following.

- The overall QBID cannot exceed 20% of taxable income less capital gain. That restriction applies to all taxpayers regardless of income. When income exceeds the taxable income threshold, the 50% of W-2 wages limitation and qualified property limit are phased in.[106]
- The prior §199 DPAD no longer exists except as resurrected for agricultural and horticultural cooperatives, as discussed previously. The 20% QBID of §199A is available for sole proprietorships and pass-through businesses. For farming businesses structured in this manner, the tax benefit of the 20% QBID likely outweighs what the DPAD would have produced.
- While those operating as a C corporation cannot claim a QBID, the corporate tax rate is now a flat 21%.[107] That represents a tax increase for those corporations that would have otherwise triggered a 15% rate under prior law and benefited from DPAD in prior years.
- For C corporations that are also patrons of an agricultural cooperative, the cooperative's DPAD does not pass through to the patron.
- For a Schedule F farmer that is a patron of an agricultural cooperative and pays no wages, there are two steps to calculate the tax benefits. First, the cooperative's DPAD that is passed through to the patron can be applied to offset the patron's taxable income regardless of source. Second, the farmer/patron is entitled to a QBID equal to 20% of net farm income derived from qualified noncooperative sales, subject to the taxable income limitation (in 2021, $329,800 (married filing jointly (MFJ)); $164,900 (other filing statuses)).[108]
- For farmers that pay Form W-2 wages and sell to agricultural cooperatives, the QBID is calculated on the sales to cooperatives by applying the lesser of 50% of W-2 wages or the 9% reduction limitation. For a farmer with farm income beneath the taxable income limitation, the QBID is never less than 11% (i.e., 20% - 9%). If the farmer is above the taxable income limitation, the 50% of W-2 wages limitation is applied before the 9% limitation. This results in the farmer's QBID, which cannot exceed 20% of taxable income. Any pass-through DPAD from the cooperative is added to this amount to produce the total deductible amount.[109]
- For farmers that sell agricultural products to noncooperatives and pay Form W-2 wages, a deduction of 20% of net farm income is available. If taxable income is less than net farm income, the deduction is 20% of taxable income minus capital gains. If net farm income exceeds the taxable income limitation, the deduction may be reduced on a phased-in basis.

PROPOSED REGULATIONS

After the 2018 change, proposed regulations were issued concerning the computation of the §199A(g) amount.[110] The proposed regulations clarified that patronage dividends include the following.

- Money
- Property
- Qualified written notices of allocations
- Qualified per-unit retain certificates for which a cooperative receives a deduction under §1382(b)

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106. IRC §§199A(g)(1)(B) and 199A(b)(3).
107. *Tax Cuts and Jobs Act,* PL 115-97, §13001.
108. Rev. Proc. 2020-45, 2020-46 IRB 1016.
109. IRC §§199A(g)(1) and 199A(a)(2).
110. Prop. Treas. Reg. §1.199A-7(c)(1).

- Nonpatronage distributions paid in money, property, qualified written notices of allocation
- Money or property paid in redemption of a nonqualified written notice of allocation for which an exempt cooperative receives a deduction under §1382(c)(2)

However, dividends on capital stock are not included in QBI.[111]

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

1. Are related to the patron's trade or business;
2. Are qualified items of income, gain, deduction, or loss at the cooperative's trade or business level; and
3. Are not income from a SSTB (as defined in §199A(d)(2)) at the cooperative level. They are only included in the patron's income if the cooperative provides the required information to the patron concerning the payments.[112]

Patron's QBID

The amount of a patron's deduction that can be passed through to the patron is limited to the portion of the patron's deduction that is allowed with respect to QPAI to which the qualified payments (patronage dividends and per-unit retains) made to the patron are attributable.[113] The distribution must be of tax items that are allocable to the cooperative's trade or business on behalf of or with a patron. The cooperative makes this determination in accordance with Treas. Reg. §1.199A-3(b). Essentially, this is the former DPAD computation except nonpatronage income is not part of the computation.

There is a 4-step process for computing the patron's QBID.[114]

1. Separate patronage and nonpatronage gross receipts (and associated deductions).
2. Limit the patronage gross receipts to those that are DPGR (likely no reduction here).
3. Determine QPAI from the domestic, patronage-sourced gross receipts.
4. Apply a formula reduction (discussed later).

Wages Issue

As noted, the farmer-patron must reduce the patron's QBID by a formula that is the **lesser of** 9% of QBI that relates to qualified payments from the cooperative, or 50% of the patron's Form W-2 wages paid that are allocable to the qualified payments from the cooperative.[115] In Notice 2019-27,[116] the IRS set forth various methods for calculating Form W-2 wages for purposes of computing the patron's QBID.[117] Because the test is the lesser of, a patron that pays no qualified W-2 wages has no reduction.

> **Note.** Under §199A(b)(4) and Prop. Treas. Reg. §1.199A-11(b)(1), wages paid in-kind to agricultural labor are not qualified wages. However, wages paid to children under age 18 by their parents are qualified wages.

111. Prop. Treas. Reg. §1.199A-7(c)(1).
112. Prop. Treas. Reg. §1.199A-7(c)(2).
113. IRC §199A(g)(2)(E).
114. Prop. Treas. Reg. §1.199A-8(b).
115. IRC §§199A(b)(7)(A)–(B).
116. IRS Notice 2019-27, 2019-31 IRB 484.
117. See also Prop. Treas. Reg. §1.199A-11.

IRC §199A(b)(7) requires the formula reduction even if the cooperative does not pass through any of the §199A(g) deduction (the deduction for a patron) to the patron for a particular tax year. If the patron has more than a single business, QBI must be allocated among those businesses.[118] The proposed regulations do not mention how the formula reduction functions in the context of an aggregation election. For example, if an aggregation election is made to aggregate rental income with income from the farming operation, it is not clear if an allocation must be made for a portion of the rental income as part of the formula reduction.

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

An optional safe harbor allocation method[119] exists for patrons with taxable income under the applicable threshold of §199A(e)(2) to determine the reduction. Under the safe harbor, a patron must allocate the aggregate business expenses and Form W-2 wages ratably between income from qualified payments and income from other than qualified payments to determine QBI.[120]

The amount of deductions apportioned to determine QBI allocable to qualified payments must be equal to the proportion of the total deductions that the amount of qualified payments bears to total gross receipts used to determine QBI. The same proportion applies to determine the amount of Form W-2 wages allocable to the portion of the trade or business that received qualified payments.

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

Observation. Thus, the patron must know the qualified payments from the cooperative that were allocable to them to determine the amount of their pass-through deduction. The information is then found on Form 1099-PATR, box 7.

A patron with taxable income above threshold levels that receives patronage dividends (or similar payments) from a cooperative and is conducting a trade or business might be subject to the Form W-2 wages and unadjusted basis immediately after acquisition (UBIA) limitation. In that instance, the patron calculates the Form W-2 wage and UBIA limitations without regard to the cooperative's Form W-2 or UBIA amounts.[121] That means the cooperative (unlike a relevant pass-through entity (RPE)) does not allocate its Form W-2 wages or UBIA to patrons. Instead, a patron allocates (by election) Form W-2 wages and UBIA between patronage and nonpatronage income using any reasonable method based on all the facts and circumstances. The reasonable method must clearly reflect the income and expense of each trade or business.[122]

118. Treas. Reg. §1.199A-3(b)(5).

119. Treas. Reg. §1.199A-7(f)(2)(ii).

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

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

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

The patron's QBID that is passed through from the cooperative (which is not limited by Form W-2 wages at the patron level) is limited to the patron's overall taxable income taking into account the nonpatron QBID which is limited to 20% of taxable income not counting net capital gains. Any unused patron-QBID is simply lost—there is no carryover or carryback provision that applies.

Identification by the Cooperative

A cooperative must identify the amount of a patron's deduction that it is passing through to a patron in a notice mailed to the patron via Form 1099-PATR during the **applicable payment period** — no later than the 15th day of the ninth month following the close of the cooperative's tax year.[123]

A patron uses the information that the cooperative reports to determine the patron's QBID. If the information is not received on or before the Form 1099-PATR due date, no distributions from the cooperative will count towards the patron's QBI if the lack of reporting occurs after June 19, 2019.[124]

FINAL REGULATIONS[125]

On January 14, 2021, the IRS issued final regulations on the cooperative QBI issue. The final regulations make several changes to the proposed regulations. One clarification that likely will not impact many farmers requires a cooperative to separately determine the amounts of qualified items that relate to nonspecified service trades or business (non-SSTBs) and those that relate to SSTBs when making distributions to patrons.[126] The cooperative is to report the net amount of qualified items from non-SSTBs in distributions to patrons without delineating on a business-by-business basis. Once a patron receives the information from the cooperative, the patron must determine if the qualified item is includible in the patron's QBI under Treas. Reg. §1.199A-7(c)(2) and whether the qualified item from the SSTB is includible in the patron's QBI based on the threshold rules of §199A(d)(3).[127]

Example 5. Peter is a grain farmer with $45,000 of QBI from his grain trade or business in 2020. His QBI consists of $105,000 of sales to an independent grain elevator, $100,000 of per-unit retain allocations, and $50,000 of patronage dividends from a nonexempt cooperative, for which the cooperative reports $150,000 of qualified payments to Peter as required by Treas. Reg. §1.199A-7(f)(3). Peter's grain trade or business has expenses of $210,000 (including $30,000 of Form W-2 wages). Peter delivered 65 bushels of grain to the cooperative and sold 35 bushels of comparable grain to the independent grain elevator.[128]

To allocate the expenses between qualified payments of $150,000 ($45,000 + $105,000) and other income ($105,000), Peter compares the 65 bushels of grain delivered to the cooperative to the 100 total bushels of grain delivered to the cooperative and sold to the independent grain elevator (65 + 35). Peter determines that $136,500 ((65 ÷ 100) × $210,000 expenses) of expenses, including Form W-2 wages of $19,500 ((65 ÷ 100) × $30,000) are properly allocable to qualified payments. The portion of QBI from Peter's grain trade or business related to qualified payments received from the cooperative is $13,500 ($150,000 qualified payments – $136,500 properly allocable expenses). Peter's method of allocating expenses and Form W-2 wage based upon assets sold is a reasonable method.

123. IRC §199A(g)(2)(A); Prop. Treas. Reg. §1.199A-8(d)(3); IRC §1382(d).
124. Prop. Treas. Reg. §1.199A-7(c)(3); Prop. Treas. Reg. §1.199A-7(d)(3).
125. TD 9947, 2021-6 IRB 748.
126. Treas. Reg. §§1.199A-7(c)(3) and (d)(3).
127. Treas. Reg. §1.199A-7(d)(3)(i).
128. Example taken from Treas. Reg. §1.199A-7(g).

Under the proposed regulations, a question existed whether a patron needed to include gain on selling farm equipment, farm program payments, self-rentals, or other similar income sources in the calculation of the §199A(g) amount. The final regulations did not answer the question. Under the final regulations, when calculating the §199A(b)(7) reduction, a patron is to use a reasonable method to allocate income between that from qualified payments and that not coming from qualified payments, based on all the facts and circumstances.[129] Consequently, a farmer/patron can make their own decision with respect to including or excluding such items. The only requirement is that a reasonable method is used.

The final regulations specify that a farmer/patron that aggregates a rental real estate business and a farming business that does business with a cooperative is to exclude the rental income when calculating the §199A(b)(7) reduction for the patron's aggregated trade or business. Similarly, the patron allocates rental expense against qualified payments when computing the reduction only to the extent rental expense is related to the qualified payments from the cooperative.[130]

On the wage issue, qualified payments need not be reduced if the cooperative was limited by the 50% of wage limitation.

The final regulations provide an example of the effect of negative QBI on the §199A(b)(7) reduction, pointing out that negative QBI from a cooperative results in no adjustment to the reduction computation:

Example 6. Farmer Smith conducts two types of agricultural business (Alpha and Bravo). For purposes of the §199A(a) deduction, Farmer Smith treats Alpha and Bravo as one trade or business. Farmer Smith conducts Alpha with nonspecified cooperatives and Bravo through a specified cooperative. He generates $100 of qualifying income through Alpha and receives $100 of qualifying income from a specified cooperative in Bravo, all of which is also a qualified payment. Farmer Smith has $180 of qualified expenses. For purposes of the §199A(a) deduction, Farmer Smith's QBI from the trade or business of $20 is used to calculate the deduction, resulting in a $4 deduction. Farmer Smith then must determine if there is an §199A(b)(7) reduction to this amount.[131]

Farmer Smith reasonably allocates his qualified expenses for purposes of calculating the §199A(b)(7) reduction. He determines that $110 of the qualified expenses are allocable to Bravo and $70 to Alpha. Farmer Smith will use only QBI from Bravo to calculate the §199A(b)(7) reduction because that is the only QBI properly allocable to qualified payments. Farmer Smith's QBI for purposes of §199A(b)(7)(A) is negative $10, resulting in a $0 reduction, regardless of Form W-2 wages under §199A(b)(7)(B).

Business	Alpha	Bravo	Total
Income	$100	$100	$200
Expense	70	110	180
QBI	30	(10)	20
QBID		0	4

Note. The final regulations are generally applicable to tax years beginning after January 19, 2021 but can be used for earlier tax years. Otherwise, for tax years beginning on or before January 19, 2021, the proposed regulations apply.

129. Treas. Reg. §1.199A-7(f)(2)(i).

130. Preamble to TD 9947.

131. Example taken from the preamble to TD 9947.

FARMLAND LEASE INCOME: PROPER TAX REPORTING

REPORTING FARMLAND LEASE INCOME

Farmland lease income may be reported on one of three possible IRS forms: Schedule F*;* Form 4835, *Farm Rental Income and Expenses;* and Schedule E, *Supplemental Income and Loss.* The appropriate form depends on whether the landlord materially participates in the farming operation. Generally, a landlord receiving cash rent should file Schedule E to report the rental income. The income is not from a farming operation, but from a rental. Reporting the rental income on Schedule E also does not trigger the application of self-employment (SE) tax. Regarding SE tax, by statute, rents from real estate and personal property leased with real estate are not considered trade or business income.[132]

If the lease is a crop or livestock share-rent arrangement, a materially participating landlord reports the income on Schedule F. If a share-rent landlord does **not** materially participate, the landlord reports the income on Form 4835. For lease income reported on Schedule F, SE tax applies. Any portion of the rental income that relates to the rental of real estate improvements (e.g., a farm building or grain bin) should be reported on Schedule E.

Material Participation

Material participation is a key concept in the proper reporting of crop/livestock share-lease income. If the landlord materially participates under the lease, the landlord's rental income is reported on Schedule F and subject to SE tax.

For purposes of SE tax imposed under IRC §1402, a landlord materially participates if **all three** of the following conditions are satisfied.

1. There is an arrangement between the owner (landlord) of the property and another person, that provides that the other person is to produce agricultural/horticultural commodities on that land.
2. Under the arrangement, the landlord is to materially participate in the production or the management of the production of the commodities.
3. The landlord actually materially participates.[133]

A landlord also materially participates if the landlord satisfies **any one** of the four following tests.

Test 1. The landlord does any **three** of the following.

- Advance, pay, or be responsible for at least half the direct cost of producing the crop;
- Furnish at least half the tools, equipment, and livestock used in producing the crop;
- Consult with the tenant; or
- Inspect the production activities periodically.

Test 2. The landlord is regularly and frequently involved in making management decisions substantially contributing to or affecting the success of the enterprise.

Test 3. The landlord works 100 hours or more over a period of five weeks or more in activities connected with crop production.

Test 4. The landlord performs activities that, **considered in their total effect,** show that the landlord is materially and significantly involved in the production of the farm commodities.

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132. IRC §1402(a).

133. IRC §1402(a)(1).

In situations in which a farmer either owns land outright or in an entity and cash leases the land to a farming entity in which the farmer materially participates, the rental income can be subject to SE tax unless the lease rate is set at FMV and there is no connection between the lease and the farmer's employment agreement with the farming entity.[134] To bolster those points, the lease should be in writing and the labor provided to the farming entity should be under a separate written employment agreement calling for reasonable compensation.

> **Note.** While many farm landlords have only a verbal agreement with the tenant, clearly a written lease makes establishing the presence of material participation easier. While the presence of material participation causes the rental income to be subjected to SE tax, it also can be beneficial for other tax and nontax reasons — including for post-death estate planning purposes.

CASH-RENT INCOME: POTENTIAL DRAWBACKS

While cash rent income is not subject to SE tax, other tax implications should be considered, such as the following.

- The rental income is not treated as gross farm income for the exception to the estimated tax penalty.[135]
- The income **does not** count for the special treatment of soil and water conservation expenditures under IRC §175.
- The income **does** count for the exclusion of cost-sharing payments under IRC §126.
- The income is also potentially subject to the passive loss limitations of IRC §469.
- The income **does not** count for purposes of expense-method depreciation under IRC §179.
- With a very minor exception, farmland subject to an election under IRC §2032A cannot be cash rented during the 10-year period following the date of the decedent's death. Related-party rents are one type of exception.
- Cash rental income is not considered earned income. For a farm landlord under full retirement age who receives social security benefits, cash-rent income does not diminish the benefits. It will also not boost future social security benefits. However, the additional income might increase the taxable portion of social security benefits.
- Income may be subject to net investment income tax (NIIT) and may or may not be QBI.

SELLING FARM BUSINESS ASSETS: SPECIAL TAX TREATMENT

In general, gains and losses arising from the sale of business assets receive a special form of tax treatment. This advantageous tax provision is IRC §1231. Assets that receive this special tax treatment are known as **§1231 assets.**

Eligible farm assets include the following.

- Farmland
- Depreciable assets used in the farm business
- Draft, breeding, dairy, and sporting livestock
- Unharvested crops sold with the land

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134. *Martin v. Comm'r,* 149 TC 293 (2017).

135. IRC §6654(i).

BASIC STRUCTURE

Upon the sale or exchange of §1231 property, the result is either capital gain or ordinary loss. Net gains from the sale of §1231 assets are long-term capital gains. As such, they are taxed at favorable rates. Currently, long-term capital gains are taxed at the rate of 0%, 15%, or 20%, depending on a combination of the taxpayer's taxable income and filing status. For a husband and wife filing jointly, the 20% rate starts at an income above $501,600. The capital gain rate for a married couple filing jointly is zero up to an income level of $80,800.[136]

If the losses on §1231 transactions exceed the gains, the net loss is treated as an ordinary loss. That is also a favorable outcome for the taxpayer as ordinary losses are not subject to the $3,000 per year deduction limitation.

> **Note.** This favorable tax treatment can only be achieved if **all** eligibility requirements for IRC §1231 are satisfied.

SCOPE OF §1231 PROPERTY

Use Issue: Burden of Proof

To be considered §1231 property, the property must be used in the taxpayer's trade or business.[137] The property cannot be held for sale to customers. The property must also be subject to depreciation and held for more than one year.[138] Real property also qualifies if it is used in the taxpayer's trade or business and held for more than a year.[139]

Property is **not** considered §1231 property if any of the following apply.

- It is inventory property.
- It is property held primarily for sale to customers in the ordinary course of business.
- It is a copyright, literary, musical or artistic composition, or a U.S. government publication.[140]

The taxpayer bears the burden to establish that property qualifies as §1231 property. For instance, in *Gettings v. Comm'r*,[141] the court held that sales of cattle were not eligible for capital gain treatment because the taxpayer could not prove that the cattle were **not** held for sale to customers in the ordinary course of business or that the cattle were depreciable assets. The Tax Court noted the taxpayer considered all his cattle as available for sale at any time.

By statute, §1231 assets include the following.

- Timber, coal, and iron ore;[142]
- Cattle and horses that the taxpayer holds for draft, dairy, or sporting purposes and that are held for 24 months or more from the date of acquisition;[143]
- Other livestock that is held for draft, dairy, or sporting purposes and that are held for 12 months or more;[144]
- Unharvested crops on land that is used in the taxpayer's trade or business and held for more than one year if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted at the same time to the same person).[145]

> **Note.** Poultry is not considered livestock for purposes of §1231.

136. IRC §1(h).
137. IRC §1231(b).
138. IRC §1231(b)(1).
139. Ibid.
140. IRC §§1231(b)(1)(C)–(D).
141. *Gettings v. Comm'r,* TC Memo 1988-328 (Jul. 27, 1988).
142. IRC §1231(b)(2).
143. IRC §1231(b)(3)(A).
144. IRC §1231(b)(3)(B).
145. IRC §1231(b)(4).

Determining Use. The requirement that the asset be held for use in the taxpayer's trade or business is key.[146] Income from the sale of assets that are held primarily for sale to customers in the ordinary course of business does not receive §1231 treatment. The regulations and the courts indicate that the reason or purpose for which a taxpayer holds an animal is based on the facts. A key fact in that determination is **how** the taxpayer uses any particular animal. Thus, an animal that is held for ultimate sale to customers in the ordinary course of the taxpayer's business may still be deemed held for draft, dairy, or breeding purposes.[147] The examples in the regulations under Treas. Reg. §1.1231-2(b)(2) are very helpful illustrations of how the use of an animal impacts eligibility for §1231 treatment.

The caselaw is also helpful in defining the scope of §1231. In *Contra Biltmore Co. v. U.S.*,[148] the issue was whether property was held primarily for sale to customers or was property used in the taxpayer's trade or business. The property included bull-calves that were between six and 11 months old, and heifer-calves that were between six and 24 months old. A dairy cattle herder raised and sold the animals. The IRS prevailed on its argument that bulls and heifers that were sold **before** they reached the age of productivity were **not** §1231 assets, even though the taxpayer retained them as standby replacements. Likewise, calves of a producing herd were held to **not** constitute §1231 property.[149] The court determined that the calves were the production of §1231 property.

In *Bandes v. Comm'r*,[150] the issue was whether the sale of pregnant gilts was properly characterized as long-term capital gain under §1231. The taxpayer retained two females from each litter purportedly for breeding purposes. The Tax Court disallowed §1231 treatment upon a finding that the taxpayers did not intend to hold the gilts for breeding purposes. Instead, the Tax Court determined the taxpayer was attempting to convert ordinary income to capital gain through the operation of §1231.

For farmers that maintain a breeding herd, the herd is often culled of unfit animals. The sale of culled cows, for example, can qualify for §1231 treatment if the farmer can show that the culled cows were no longer suitable for breeding purposes or at least different from those livestock that were not sold. The **motive to cull** is controlling rather than **when** the culling occurred or **how** the animals were culled. However, if heifers are culled shortly before the annual spring sale, that may cause the IRS to question the purpose for which the heifers are held.[151] If the facts indicate that that taxpayer was in the business of selling stock for breeding purposes, a court is likely to deny §1231 treatment for the culled animals.[152]

Note. A taxpayer should clearly identify the motive for sale of various types of livestock to properly classify gains as ordinary or capital. In addition, the IRS could assess SE tax on the sale proceeds for nonbreeding stock animals. Relevant to that determination is the degree of marketing and promotion of the annual spring sale.

146. IRC §1231(a).

147. Treas. Reg. §1.1231-2(b)(1).

148. *Contra Biltmore Co. v. U.S.,* 129 F. Supp. 366 (W.D.N.C. 1955), *aff'd* 228 F.2d 9 (4th Cir. 1955).

149. *Fox v. Comm'r,* 198 F.2d 719 (4th Cir. 1952).

150. *Bandes v. Comm'r,* TC Memo 1982-355 (Jun. 23, 1982).

151. See, e.g., *Hillman v. U.S.,* 2002-2 USTC ¶ 50,700 (D. S.D. 2002).

152. See e.g., *A. Duda & Sons, Inc. v. U.S.,* 560 F.2d 669 (5th Cir. 1977), *rev'g* 383 F. Supp. 1303 (M.D. Fla. 1974).

Other Situations

An animal can still be determined held for a breeding purpose if it is disposed of within a reasonable time after its intended use is prevented or made undesirable by reason of accident, disease, unfitness, or something similar.[153] Also, if the taxpayer's plans change and animals must be sold, §1231 treatment might be proper.[154] Similarly, weather can play a role. In *Carter v. Comm'r*,[155] the taxpayer bought heifers to start a breeding herd. They sold them shortly thereafter because weather conditions made feeding difficult. The court held that §1231 treatment was available for the sale of the heifers.

With respect to the sale of pregnant breeding stock, the question is whether an allocation of a portion of the selling price must be made to the unborn young. The Tax Court has said that no allocation is required. In *Metz v. U.S.*,[156] the Tax Court reasoned that allocation was not required to an unborn because of the uncertainty of a successful birth.

For horses, if a horse is held for racing purposes (e.g., for racing at a public track or a horse trained for racing purposes) the regulations, in general, consider the horse held for sporting purposes.[157] However, if a horse has never been raced or trained for racing, it is likely not considered held for racing purposes. Horses used for team roping may present a problem for the taxpayer in establishing the existence of a trade or business — a prerequisite for §1231 treatment.[158] A colt that is not fit for sporting purposes can still qualify for §1231 treatment even if it has not been trained fully or raced. For instance, in *Kirk v. Comm'r*,[159] the Tax Court held that horses that were culled because they were not adequate for use as harness horses in the hands of a professional harness racer qualified for §1231 treatment.

In *Bradshaw v. U.S.*,[160] the plaintiff kept approximately four stallions and 35 mares for breeding. Normally, about 25 foals were born each year. After weaning in the fall, the plaintiff culled the foals and sold them at public auction before they were trained. The plaintiff reported the gain as ordinary income. The rest of the yearlings were broken to bridal and lead. Throughout the training process, some of the horses were determined to be undesirable for showing or breeding. These horses continued to train, but they were classified as "cull" and sold at private sales. The IRS claimed the plaintiff was in the business of selling show horses and that if a buyer wanted to purchase any horse on his farm, the owner would sell the horse and report the gain as long-term capital gain. The horses sold included mares, stallions, and geldings. Geldings cannot be used for breeding purposes, so the plaintiff relied on the general provisions of §1231(b)(1) (an asset used in the trade or business that is subject to depreciation and has been held for more than one year) rather than the more specific provisions of §1231(b)(3) (the provision for livestock). The court cited the *Kirk* case for the proposition that the existence of the §1231(b)(3) did not preclude the horses from qualifying under the general provisions of §1231(b)(1). The IRS did not appeal. However, it issued an Action on Decision stating that the decision was probably wrong. It stated the sold horses were not segregated from the remaining horses and were kept in training and sold only when buyers selected them for purchase. However, the IRS noted the jury verdict was not clearly erroneous.[161]

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153. Treas. Reg. §1.1231-2(b)(1).

154. See, e.g., *Coldwater Cattle Co. v. U.S.,* No. 2756-Civil, 1961 U.S. Dist. LEXIS 5430 (N.D. Tex. Jan. 9, 1961); *Clingman v. U.S.,* No. F-75-194 Civ., 1977 U.S. Dist. LEXIS 17033 (E.D. Cal. Mar. 7, 1977).

155. *Carter v. Comm'r,* 257 F2d 595 (5th Cir. 1958).

156. *Metz v. U.S.,* No. 1446, 1962 U.S. Dist. LEXIS 5176 (E.D. Ky. Mar. 27, 1962).

157. Treas. Reg. §§1.1231-2(c)(1) and (c)(1)(i).

158. See e.g., *Gallegos v. Comm'r,* TC Memo 2021-25 (Mar. 2, 2021).

159. *Kirk v. Comm'r,* 47 TC 177 (1966), *acq* 1967-1 CB 2.

160. *Bradshaw v. U.S.,* No. 2154, 1971 U.S. Dist. LEXIS 10564 (E.D. Ky. Dec. 1, 1971).

161. 1971 AOD LEXIS 486 (Dec. 10, 1971).

For embryo transplants, the animal from which the embryo came is the §1231 asset — it is deemed held for breeding purposes.[162] When the cow in which the implanted embryo is purchased, the purchase price is allocated between the cow and the embryo on the basis of the FMV of each. The cost allocated to the embryo is capitalized. The resulting calves that are born from the embryo implantation trigger ordinary income (or loss) on sale if they are held for sale to customers in the ordinary course of business. With respect to embryo transplant services, however, the IRS is attentive to sham transactions. Investments in cattle breeding operations may be suspect from the IRS standpoint. The transaction must have economic substance. If not, the IRS disregards the transaction.[163]

Definition of Livestock

Livestock is broadly defined for §1231 purposes. The term includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals.[164] The term can also include trophy deer that are raised as part of a taxpayer's farming trade or business.[165] The term includes any mammal held for breeding or sporting purposes. However, livestock for §1231 purposes does not include poultry, chickens, turkeys, pigeons, geese, other birds, fish, frogs, or reptiles.[166] Livestock also includes some furbearing animals. Chinchilla count if the taxpayer holds them for breeding purposes.[167] Mink and fox also count.[168] Likewise, culled mink pelts also can be treated as a §1231 asset in the hands of a taxpayer engaged in the trade or business of raising mink for the purpose of selling mink pelts.[169] Bees (and probably, other insects) are not livestock for §1231 purposes.[170]

Holding Period. To receive §1231 treatment, livestock must be held for a qualified purpose (draft, dairy, breeding, or sporting purposes) and a taxpayer must hold the livestock for a required amount of time.[171] For cattle and horses, the holding period is at least 24 months.[172] For all other livestock, the holding period is at least 12 months.[173]

Measuring — General Rule.[174] A taxpayer determines whether the holding period was satisfied by not counting the day on which an asset was acquired and **including** the day on which the asset was sold.

Measuring — Sale by an Estate. Property included in a decedent's estate at death that receives a basis equal to the FMV of the property at death under IRC §1014 is treated at having been held for more than one year.[175] It does not matter how long the taxpayer actually held the property before death.[176] Likewise, for property that a decedent holds until the date of death, if it is disposed of within 18 months after the decedent's death, it is deemed to have been held more than 18 months.[177] However, this rule does not apply to livestock — the special holding periods for livestock contained in §§1231(b)(3)(A)–(B) continue to apply.[178] Thus, the decedent must have held the livestock for the applicable holding period before death for the heir to receive long-term capital gain treatment upon sale by the estate.

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162. Rev. Rul. 86-24, 1986-1 CB 80; Treas. Reg. §1.1231-2(b)(1).
163. See e.g., *In re Gran,* 964 F.2d 822 (8th Cir. 1992); *Boyer v. Comm'r,* TC Memo 1992-724 (Dec. 22, 1992).
164. Treas. Reg. §1.1231-2(a)(3).
165. See TAM 9615001 (Oct. 17, 1995).
166. Treas. Reg. §1.1231-2(a)(3).
167. *Greer v. Comm'r,* 17 TC 965 (1951), *acq* 1953-1 CB 4.
168. Rev. Rul. 57-88, 1957-1 CB 88.
169. *U.S. v. Cook,* 270 F.2d 725 (8th Cir. 1959).
170. *Sykes v. Comm'r,* 57 TC 618 (1972).
171. IRC §1231(b)(3).
172. IRC §1231(b)(3)(A).
173. IRC §1231(b)(3)(B).
174. Rev. Rul. 66-7, 1966-1 CB 188; *Caspe v. U.S.,* 694 F.2d 1116 (8th Cir. 1982).
175. IRC §1223(9).
176. Ibid.
177. IRS Notice 97-59, 1997-2 CB 309.
178. Rev. Rul. 75-361, 1975-2 CB 344.

The Netting Process.[179] Net gains from §1231 assets are long-term capital gains. If losses are greater than gains, the net loss is treated as an ordinary loss. If net §1231 losses exceed net §1231 gains, the gains and losses are not treated as gains and losses from sales or exchanges of capital assets and instead are treated as ordinary.

Example 7. In 2020, Sam and Sarah had the following sales transactions associated with the conduct of their farming business.

- Quarter section of land acquired in 2006: Basis of $850,044; selling price of $1,065,000
- Truck acquired over one year earlier: Purchase price of $42,050; depreciation of $30,000; selling price of $10,000
- Two raised bulls used for breeding and held for more than two years: selling price of $6,500
- 14 raised cows used for breeding and held for more than one year: selling price of $15,050

During 2020, Sam and Sarah also sold a combine, a tractor and five purchased cows, each of which they held for use in their farming business for more than two years. They file the following Form 4797, *Sales of Business Property*.

179. IRC §1231(a)(2).

For Example 7

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

► Attach to your tax return.
► Go to *www.irs.gov/Form4797* for instructions and the latest information.

OMB No. 1545-0184
2020
Attachment Sequence No. 27

Name(s) shown on return	Identifying number
Sam and Sarah Stone	222-00-1111

1 Enter the gross proceeds from sales or exchanges reported to you for 2020 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions	1	1,065,000

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
Quarter Section of Land	08/01/06	08/11/20	1,065,000		850,044	214,956
Truck	06/13/19	10/01/20	10,000	30,000	42,050	(2,050)
2 Raised Bulls	03/01/18	06/15/20	6,500			6,500
14 Raised Cows	02/15/14	06/15/20	15,050			15,050

3 Gain, if any, from Form 4684, line 39	3	
4 Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5 Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6 Gain, if any, from line 32, from other than casualty or theft	6	
7 Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	7	234,456

Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.

Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.

8 Nonrecaptured net section 1231 losses from prior years. See instructions	8	
9 Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions	9	

Part II **Ordinary Gains and Losses** (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11 Loss, if any, from line 7	11	( )
12 Gain, if any, from line 7 or amount from line 8, if applicable	12	
13 Gain, if any, from line 31	13	303,250
14 Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15 Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16 Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17 Combine lines 10 through 16	17	303,250

18 For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below.

a If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the loss from income-producing property on Schedule A (Form 1040), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions	18a	
b Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040), Part I, line 4	18b	303,250

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (2020)

For Example 7

Form 4797 (2020) Page 2

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255** (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Combine	12/01/14	03/01/20
B Tractor	01/22/15	07/14/20
C 5 Purchased Cows	09/07/17	06/15/20
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	175,000	125,000	5,000	
21 Cost or other basis plus expense of sale	21	322,000	240,000	6,500	
22 Depreciation (or depletion) allowed or allowable	22	322,00	240,000	4,750	
23 Adjusted basis. Subtract line 22 from line 21	23			1,750	
24 Total gain. Subtract line 23 from line 20	24	175,000	125,000	3,250	
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a	322,000	240,000	4,750	
b Enter the **smaller** of line 24 or 25a	25b	175,000	125,000	3,250	
26 **If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975. See instructions	26a				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a. See instructions	26b				
c Subtract line 26a from line 24. If residential rental property **or** line 24 isn't more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 **If section 1252 property:** Skip this section if you didn't dispose of farmland or if this form is being completed for a partnership.					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage. See instructions	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion. See instructions	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126. See instructions	29a				
b Enter the **smaller** of line 24 or 29a. See instructions	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	303,250
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	303,250
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	0

Part IV **Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less** (see instructions)

		(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33		
34 Recomputed depreciation. See instructions	34		
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

Form **4797** (2020)

Unharvested Crops Sold with Land

For land that is sold with an unharvested crop, if both the land and the growing crops are used in the seller's trade or business of farming and are sold (or exchanged or compulsorily or involuntarily converted) to the same buyer in a single transaction, the land and crops are considered property used in the trade or business.[180] If the seller held the land more than a year before the sale, §1231 treatment is available.[181] However, special rules apply if the taxpayer is on the cash method. In this situation, when computing taxable income, the seller cannot claim any deductions for the unharvested crop attributable to the crop's production either for the tax year of sale or not. The seller must capitalize the costs of raising the crop.[182]

Section 1231 treatment is **not** available for an unharvested crop if the seller retains any right or option, either directly or indirectly, to reacquire the land that the crop is growing on.[183] For this purpose, a right that is incident to a mortgage (or other security interest) is not considered to be a "right or option."[184]

Note. A leasehold or an estate for a term of years is not land for purposes of §1231.[185] Thus, when a crop is raised on land where the taxpayer (as landlord) sells the lease and the unharvested crop in one transaction, the sale results in ordinary income.[186]

The sale of raised crops or livestock in the estate of a decedent that was an active farmer generally results in ordinary income recognition. Sale of land by an estate, on which crops constituting property are growing, results in capital gain treatment for the income attributable to the crop.[187] If the crops are harvested during the process of liquidating the farming business and selling the land, it might be possible to characterize the sale of the crops as part of the liquidation and achieve capital gain treatment.

Sale of Water

Whether a sale of water qualifies for §1231 treatment depends on whether the seller retains a continuing interest in the water.[188] If the seller retains an economic interest, the gain on sale is treated as ordinary income. This includes reserving the right to use water for livestock purposes when it does not amount to a sale of the water in place.[189]

In the *Vest* case, the taxpayers owned land and associated water and mineral rights. The Shell Oil Company (Shell) proposed to buy the water rights along with a right-of-way so the water and mineral rights could more easily be developed. The taxpayers entered into a contract with Shell to transfer the water rights to all water between 3,000 and 6,500 feet beneath their land. The taxpayers reserved enough water for their own exploration and production of minerals. Ultimately, Shell paid the taxpayers over $26,000 for the water that it extracted and transported from the property of neighboring landowners. The taxpayers reported the income as capital gain, but the IRS determined that it was ordinary income from a lease. The Tax Court ruled against the IRS, determining the transaction between the parties amounted to a sale of the water in place and a permanent interest in the property for a right-of-way.

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180. IRC §1231(b)(4).
181. Treas. Reg. §1.1231-1(c)(5).
182. IRC §268.
183. Treas. Reg. §1.1231-1(f); Ltr. Rul. 8504014 (Oct. 22, 1984).
184. Treas. Reg. §1.1231-1(f).
185. Ibid.
186. *Bidart Brothers v. U.S.,* 262 F.2d 607 (9th Cir. 1959).
187. IRC §§268 and 1231(b)(4).
188. *Vest v. Comm'r,* 57 TC 128 (1971), *aff'd* 481 F.2d 238 (5th Cir. 1973).
189. *Puckett v. Comm'r,* TC Memo 1964-40 (Feb. 24, 1964), *aff'd* 355 F.2d 551 (5th Cir. 1966).

On further review, the appellate court noted that the transaction was not easy to categorize because it contained elements of both a lease and a sale. Ultimately, the appellate court determined that the taxpayers had retained an economic interest in the water rights and the right-of way. The taxpayers simply had not transferred to Shell all the water in place or a specific quantity of it, and Shell controlled the conditions under which its obligation arose to make payment over a 75-year timeframe. It had no duty to extract any "purchase price water" at all and, if it did not, the taxpayers would receive nothing. The appellate court noted this relationship between payment and production meant the taxpayers had retained an economic interest in the water rights that had been transferred to Shell and that proceeds from the transaction were ordinary income.

Note. In *Gladden v. Comm'r,*[190] the Tax Court held that the water rights that the petitioners relinquished in the Colorado River were capital assets because the allocation of the rights was directly linked to the capital investment in the land. As such, the transaction amounted to a sale or exchange.

Self-Rental of Livestock

When the taxpayer leases livestock that otherwise qualify for §1231 to an entity that the taxpayer owns, additional review is needed to determine if §1231 tax treatment may apply. In *Dudden v. Comm'r*,[191] the taxpayers (a married couple) were the sole shareholders of a farming corporation engaged in the trade or business of raising hogs. They held title to brood sows and gilts (the breeding herd) and leased the animals to the corporation under a sow lease agreement. Under the lease, the corporation was given possession of the breeding herd. As noted, the taxpayers retained legal title to the sows and gilts. Sows were kept for about two years (roughly five breedings) before the corporation culled them and returned them to the taxpayers. When a sow was culled, one gilt was placed in the breeding herd as a replacement. Title to the gilt remained with the taxpayers. Consequently, the breeding herd was constantly maintained at 150 sows.

The taxpayers sold the culled sows (which were raised sows) and reported the gain as a §1231 gain. They took the position that the lease did not trigger gain because it was a mere bailment — title to replacement gilts never vested in the corporation and the corporation could not sell replacement gilts. The corporation was entitled to all pigs farrowed (whether gilt or barrow), except those designated as replacement gilts. The corporation fed and cared for the replacement gilts until they reached a breeding weight of 220 pounds. The gilts were then transferred to the taxpayers and the taxpayers raised them to a breeding weight of 270 pounds at which point the gilts were reintroduced in the breeding herd via a re-lease to the corporation. A gilt pen was maintained where the replacement gilts were the ones that had superior genetics.

The IRS disagreed with the taxpayers' tax treatment of the transaction, claiming that the taxpayers received rent when a gilt was placed in the breeding herd as a beginning sow even though the taxpayers neither paid nor deducted any rent expense. The amount of the rent, according to the IRS was the slaughter value of the gilt on the day of the placement in the breeding herd. The taxpayer, according to the IRS, then had basis in the gilt that could be depreciated over the next two years. The IRS maintained the deprecation would be recaptured to the extent of the deprecation upon sale as a culled sow. Thus, the IRS's position was that the taxpayers were engaged in the trade or business of selling culled sows. The income from this should be reported on Schedule F. The IRS took this position even though the selling of culled sows was not a major part of the taxpayers' overall farming operation. It merely served as a means of getting the taxpayers' children into the farming operation without significant capital investment.

The Tax Court agreed with the IRS position.[192]

190. *Gladden v. Comm'r,* 112 TC 209 (1999).

191. *Dudden v. Comm'r,* 893 F. 2d 174 (8th Cir 1990).

192. *Dudden v. Comm'r,* 91 TC 642 (1988).

The appellate court, while noting that the lease did have characteristics of a bailment, upheld the Tax Court's determination that the taxpayers realized potential rental income when the corporation transferred the 220-pound replacement gilts to the taxpayers, and rental income when the gilts reached 270 pounds and were re-leased to the corporation. The appellate court held the rental income should have been recognized when the gilts were reintroduced into the breeding herd and re-leased to the corporation. They further noted the lease provided a means by which the taxpayers could draw income from the corporation in the form of value from the replacement gilts that they did not initially possess and did not need to buy. The appellate court pointed out that the lease stated that the transfer of replacement gilts constituted consideration for the lease — they were rent that the corporation paid in exchange for the right to use the taxpayers' breeding herd, a breeding herd that the taxpayers held title to but did not have a current possessory interest in.

The appellate court noted that rent is typically taxable as ordinary income upon receipt in the hands of a cash-basis taxpayer.[193] The appellate court took the position that, under the lease, the corporation held title to the gilts farrowed and title to the replacement gilts vested in the taxpayers when the 220-pound replacement gilts were acquired under the lease. Based on this construction of the lease, there was a potential for realized income at this point in time. It then followed that when the replacement gilts reached 270 pounds (their breeding weight), the taxpayers actually realized rental income because they then had beneficial ownership (title, burden, and expense). As such, the lease was the same as a crop-share lease with the taxpayers as landlords. The rental income was recognized when the replacement gilts were re-leased to the corporation and reintroduced into the breeding herd. That was the point in time when there was an addition to capital and livestock were reduced to money or an equivalent of money. Therefore, the crop-share recognition rule applied.[194] The money equivalent (ordinary income) of the rental income could be measured from the USDA price quotation sheets for slaughter value on the date when the taxpayers selected the replacement gilts. Added to that amount would be the value of the corporation's cost of providing food and care for the gilts while they were being prepared for breeding.

Note. The appellate court's construction of the lease and computation of rental income leaves questions with unclear answers. The taxpayers maintained the title to a replacement gilt from the time of birth. There was no title transfer. Possession was transferred but that was no different than what occurred by the corporation's use of the breeding herd. In addition, the appellate court's use of USDA price quotation sheets for slaughter value of gilts to peg the rental income is questionable. A completely separate live market existed for the sale of gilts which yielded different (and more accurate) prices.

Timber

For timber farmers (those in the trade or business of harvesting and selling timber), the sale of the timber generates ordinary income. An election can be made by an owner of standing timber or a taxpayer that holds a contract right to cut timber and has held the right for more than one year. This election allows them to treat the cutting of timber as a sale or exchange that is eligible for capital gain treatment. Via the election, the taxpayer is allowed capital gain treatment on the income in the value of the timber until it is cut. A later sale generates ordinary income or loss.

Capital gain treatment is also the result when a standing timber owner disposes of timber.[195]

193. IRC §61(a)(5).

194. See Treas. Reg. §1.61-4(a)(5).

195. IRC §631(b).

Christmas Trees. Timber includes evergreen trees if they are more than six years old at the time they are cut and are sold for ornamental purposes (e.g., Christmas trees).[196] However, sale of Christmas trees on a choose-and-cut basis are not eligible for capital gain treatment.[197] Christmas trees that are less than six years old at the time of cutting are not considered timber and are subject to the capitalization rules of IRC §263A. All the costs of raising the trees must be added to basis unless the taxpayer elects out of the application of the rules.[198] If the election is made, when the trees are sold, the costs that would otherwise have been capitalized are subject to recapture as ordinary income and alternative depreciation is required.[199]

FEDERAL FARM PROGRAMS AND AGI COMPUTATION

Many farmers participate in federal farm programs and receive subsidies on a per-person basis. There are limits to the amount of subsidies that can be received. To be eligible to participate in most federal farm programs, the applicant (individual or entity) must have an average adjusted gross income (AGI) of $900,000 or less.[200]

OVERVIEW

A prerequisite to participating in many federal farm programs is annually certifying that average AGI does not exceed the $900,000 threshold. The measuring period is the prior three years, skipping the immediately prior year. The $900,000 limit applies to most USDA farm programs. However, there are some exceptions — particularly those concerning conservation or disasters. An applicant must provide the IRS with written consent to allow the USDA to verify AGI. The consent (via USDA Form CCC-941, *Average Adjusted Gross Income (AGI) Certification and Consent to Disclosure of Tax Information*) allows the IRS to verify to the FSA, based on a farm program applicant's tax return information, whether (for most farm programs) the $900,000 limit is not exceeded. The consent covers the three tax years that precede the immediately preceding tax year for which farm program benefits are being sought. Thus, for 2021, the relevant tax years are 2019, 2018, and 2017. For a farmer or a farming operation that has not been operating for the 3-year period before the immediately preceding year, the FSA uses an average of income for the years of operation.[201]

Note. Worksheets used in determining AGI calculations should be retained for at least three years.

DEFINING AGI: THE FSA WAY

As noted, average AGI is measured over the three taxable years preceding the most immediately preceding complete tax year for which benefits are requested.[202] The FSA, in its National Food Security Act Manual, 5th edition (known as the 5-PL), sets forth the table shown on the following page for guidance on determining AGI using a producer/applicant's data that has been reported to the IRS.[203]

196. IRC §631(a).

197. *Eck v. Comm'r,* 99 TC 1 (1992); Rev. Rul. 77-229, 1977-2 CB 210.

198. IRC §263A(d)(3).

199. IRC §263A(e).

200. *Agricultural Act of 2014,* PL 113-79, §1605.

201. FSA 5-PL, Para. 312, subparagraph F.

202. FSA 5-PL, Para. 293.

203. FSA 5-PL, Para. 296, subparagraph B.

If determining AGI for...	Then see IRS Form...	AND use the amount entered on...
Corporations	1120 or 1120-S	Either of the following: • Line 30 (total taxable income) plus line 19 (charitable contributions) • For S corporations, use only Form 1120-S, line 21 (ordinary business income)
Estates or trusts	1041	Line 23 (taxable income) plus line 13 (charitable deductions)
LLCs, LLPs, LP or similar type organization taxed as partnership	1065	Line 22 (total income from trade or business) plus line 10 (guaranteed payments to partners)
Persons	1040	Line 8b (AGI)
Tax-exempt or charitable organizations	990-T	Line 31 (unrelated business taxable income) minus income that CCC determines to be from noncommercial activity

Note. The line items referenced in the table are further modified by the allowance of §179 deductions for flow-through entities.[204]

For a sole proprietor filing a joint return, an exception exists from the need to report the full amount reported as AGI on the final IRS tax return for the applicable year. Under the exception, a certification may be provided by a CPA or an attorney that specifies what the AGI amounts would have been for each taxpayer if separate tax returns would have been filed for the applicable year.[205]

SCHEDULE K ISSUES

IRS Form 1120-S and Form 1065 do not refer to income or deductions reported on Schedule K-1*, Partner's Share of Income, Deductions, Credits, etc.* A Schedule K-1 is the form used to report amounts that are passed through to each taxpayer that has an interest in a flow-through entity such as an S corporation, partnership, trust, or an estate. Consequently, any §179 deduction (i.e., expense-method depreciation) would not be factored into the average AGI computation for a farming operation that is a flow-through entity seeking farm program benefits. However, the §179 deduction is taken into account for a C corporation. Therefore, a C corporation and an S corporation with identical net incomes may not be treated similarly for farm program eligibility purposes. This is particularly true for an S corporation farming entity that has AGI over the $900,000 threshold before deducting any §179 amount but is under the limitation when the §179 deduction is subtracted from income.

Threatened with litigation on this disparate treatment of S and C corporations, the FSA revised the 5-PL to reflect the rule change allowing the §179 deduction for flow-through entities as well as sole proprietorships and C corporations. However, FSA still ignores other Schedule K-1 items in the computation of AGI for purposes of the $900,000 AGI computation. At least this is the position of the national FSA. There may be variations at the local and state levels.

204. FSA 5-PL, Para. 21, subparagraph G.

205. FSA 5-PL, Para. 296, subparagraph A.

CERTIFYING INCOME: FORM CCC-941

A producer seeking farm program benefits must annually certify income to the FSA to ensure the $900,000 threshold (in most instances) is not exceeded. The producer must also provide the FSA with written consent for the IRS to use the applicant's tax information on file and disclose certain information to the FSA. The verification process starts with the FSA's referral of the certification and consent to the IRS.[206] Consent for disclosure of tax information is valid only if the IRS receives it within 120 calendar days of the date the Form CCC-941 was signed.[207]

If an attorney/CPA statement is provided, both the statement and the completed Form CCC-941 must be submitted to the local FSA office before the Form CCC-941 is considered complete and AGI is updated in the producer's file. The submitted Form CCC-941 is then sent to the IRS and the statement of the attorney/CPA is attached to a copy of the form that FSA retains.[208]

Form CCC-941 is required to determine payment eligibility for all persons; legal entities; interest holders in a legal entity, including embedded entities to the fourth level of ownership interest, regardless of the level of interest held; and, members of a general partnership or joint venture, regardless of the number of members.[209] It is submitted under the same name and tax identification number used for tax filing purposes. For example, for farm assets and land that were transferred to a revocable trust, the identification on Form CCC-941 is the grantor's name and social security number.

If Form CCC-941 is not filed for a program year, the producer is not eligible for farm program payments for that year. Any program payments erroneously paid must be returned, with interest.

> **Note.** Technically, the FSA rules state that to comply with the AGI requirement for the applicable crop, program, or fiscal year, a person or legal entity must provide **either** a completed Form CCC-941 for that year **or** a statement from an attorney/CPA that the average AGI does not exceed the applicable limitation. In all cases, the portions of Form CCC-941 pertaining to consent of disclosure of tax information must be completed and signed by the person (or entity) subject to AGI compliance.[210]

The form must be personally signed by the applicant — either in their own name or, if the application is on behalf of an entity, by the designated officer(s). If the applicant is a minor, the form can be signed by a parent or guardian. One spouse cannot sign for the other spouse unless there is a duly executed power-of-attorney (POA). Neither IRS Form 2848, *Power of Attorney and Declaration of Representative,* nor a Form FSA-211, *Power of Attorney,* is acceptable.[211]

> **Note.** A table contained in the FSA 5-PL, Amendment 4, page 6-34 at Para. 302, subparagraph C, sets forth the signature authority for Form CCC-941.

If the applicant is a grantor trust, the form must denote the grantor's name. For a deceased person, Form CCC-941 may be filed by the surviving spouse, an authorized representative, or an entity that is responsible for filing the final federal income tax return for the decedent.[212] If filing is by an authorized representative, proof of such authorization must be provided by attachment to Form CCC-941.

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206. FSA 5-PL, Para. 301, subparagraph A.
207. FSA 5-PL, Para. 301, subparagraph E.
208. FSA 5-PL, Para. 302, subparagraph A.
209. FSA 5-PL, Para. 294.
210. FSA 5-PL, Par. 294, subparagraph B.
211. FSA 5-PL, Para. 302, subparagraph C.
212. FSA 5-PL, Para. 302, subparagraph D.

Form CCC-941 authorizes the FSA to obtain AGI data from the IRS. When the IRS receives the form, it matches the identity of the name on the form with the tax records associated with the name. The IRS then calculates AGI according to the FSA's definition of the term and reports to the FSA whether the applicant is within the $900,000 threshold. If the IRS reports to the FSA that a producer is over the AGI limit, the FSA then sends the producer a letter informing them that they have 30 days to provide a third-party verification by an attorney/CPA that the producer's average AGI is within the threshold along with associated tax records. If an entity is the farmer, this letter is required for both the entity and the individual. If, upon review, the FSA still deems the producer not eligible for benefits, the producer may file an administrative appeal within 30 days of the determination.

Note. It is important for a producer/applicant to respond to the FSA within the 30-day timeframe in order to preserve administrative appeal rights. However, the FSA 5-PL does state that appeal rights exist even if requested information is not timely provided.[213]

The failure to provide the FSA with correct and accurate information to establish AGI compliance can result in ineligibility for all program payments and benefits that are subject to the AGI limitation for the applicable years. In addition, the producer/entity must refund any benefits already paid due to the incorrect information and face possible civil or criminal prosecution.[214]

A person or entity that lacks tax records or is not required to file tax returns may document AGI by providing the FSA with annual budgets and a statement of operations, annual public financial disclosures, financial statements, or any other documentation as FSA deems acceptable.

Note. Some farmers expressed concern about the information the IRS shares with the FSA. However, the IRS does not report the applicant's income, AGI (or average AGI), or any determination on the applicant's eligibility or ineligibility for farm program payments. The IRS merely computes AGI according to the FSA approach and reports to the FSA whether the producer/applicant is over or under the applicable threshold.[215] The FSA maintains in a secure database the information that the IRS provides, and the information is not subject to a Freedom of Information Act request.[216]

213. FSA 5-PL, Para. 297, subparagraph E.

214. FSA 5-PL, Para. 297, subparagraph D.

215. FSA 5-PL, Para. 303, subparagraph B.

216. Ibid, subparagraph C.

This form is available electronically.

CCC-941 (01-24-19)	**U.S. DEPARTMENT OF AGRICULTURE** Commodity Credit Corporation **AVERAGE ADJUSTED GROSS INCOME (AGI) CERTIFICATION AND CONSENT TO DISCLOSURE OF TAX INFORMATION**	**1. Return completed form to:** ***(Name and address of FSA county office or USDA Service Center)***

NOTE: *The following statement is made in accordance with the Privacy Act of 1974 (5 USC 552a - as amended). The authority for requesting the information identified on this form is 7 CFR Part 1400, the Commodity Credit Corporation Charter Act (15 U.S.C. 714 et seq.), the Food Security Act of 1985 (Pub. L. 99-198), the Agricultural Act of 2014 (Pub. L. 113-79), and the Agriculture Improvement Act of 2018 (Pub. L. 115-334). The information will be used to determine eligibility for program benefits. The information collected on this form may be disclosed to other Federal, State, Local government agencies, Tribal agencies, and nongovernmental entities that have been authorized access to the information by statute or regulation and/or as described in applicable Routine Uses identified in the System of Records Notice for USD A/FSA-2, Farm Records File (Automated). Providing the requested information is voluntary. However, failure to furnish the requested information will result in a determination of ineligibility for program benefits.*

Paperwork Reduction Act (PRA) Statement**: This information collection is exempted from the Paperwork Reduction Act as specified in 7 U.S.C. 9091(c)(2)(B). The provisions of criminal and civil fraud, privacy and other statutes may be applicable to the information provided. **PLEASE RETURN COMPLETED FORM TO FSA AT THE ABOVE ADDRESS.

2. Name and Address of Individual or Legal Entity *(Including Zip Code)* *(Use the same name and address as used for the tax return specified in Part B.)*	**3. Taxpayer Identification Number (TIN) *(Social Security Number for Individual; or Employer Identification Number for Legal Entity)***

PART A CERTIFICATION OF AVERAGE ADJUSTED GROSS INCOME

4. The program year for payment eligibility

A. 20__ **Enter the year for which program benefits are requested**. The period for calculation of the average AGI will be of the three taxable years preceding the most immediately preceding complete taxable year for which benefits are requested. For example, the 3-year period for the calculation of the average AGI for 2019 would be the taxable years of 2017, 2016 and 2015.

5. I certify that the average adjusted gross income of the individual or legal entity in Item 2 (*for the year included in Item 4*) was:

A. ☐ **Less than** *(or equal to)* **$900,000**

B. ☐ **More than $900,000**

PART B CONSENT TO DISCLOSURE OF TAX INFORMATION

Pursuant to 26 U.S.C. §6103, I hereby authorize the Internal Revenue Service (IRS) to review the following items of "return information" *(as defined in 26 U.S.C. §6103(b)(2))* from the returns *(as specified below)* of the individual or legal entity identified in Item 2 for the taxable years indicated in Item 4:

Form 1040 and 1040NR filers: farm income or loss; adjusted gross income
Form 1041 filers: farm income or loss, charitable contributions, income distribution deductions, exemptions, adjusted total income; total income
Form 1065 filers: guaranteed payments to partners, ordinary business income
Form 1120, 1120A, 1120C filers: charitable contributions, taxable income
Form 1120S filers: ordinary business income
Form 990T: unrelated business taxable income

I understand the IRS will review these items of return information in order to perform calculations, the results of which I authorize to be disclosed to officers and employees of the United States Department of Agriculture (USDA) for use in determining the individual's or legal entity's eligibility for specified payments for various commodity and conservation programs. The calculations performed by the IRS use a methodology prescribed by the USDA. In addition, I am aware that the USDA may use the information received for compliance purposes related to this eligibility determination, including referrals to the Department of Justice.

Specially, the IRS will disclose to the USDA the individual's or legal entity's name and TIN, and inform the USDA if, pursuant to its calculations, the average Adjusted Gross Income (AGI) is above or below eligibility requirements as prescribed by the Agricultural Act of 2014 or Agriculture Improvement Act of 2018. The IRS will also disclose to the USDA the type of return from which the information used for the calculations was obtained.

If the IRS is unable to locate a return that matches the taxpayer identity information provided above, or if IRS records indicate that the specified return has not been filed, for any of the taxable years indicated, the IRS may disclose that it was unable to locate a return, or that a return was not filed, for those years, whichever is applicable.

An approved Power of Attorney (Form FSA-211) on file with USDA cannot be used as evidence of signature authority when completing this form.

By signing this form:

- **I acknowledge that I have read and reviewed all definitions and requirements on Page 2 of this form;**
- **I certify that all information contained within this certification is true and correct; and is consistent with the tax returns filed with the IRS;**
- **I agree to authorize CCC to obtain tax data from the IRS for AGI compliance verification purposes by filing this form;**
- **I am aware that without this consent to disclosure, the returns and return information of the individual or legal entity identified in Item 2 are confidential and are protected by law under the Internal Revenue Code;**
- **I certify that I am authorized under applicable state law to execute this consent on behalf of the legal entity identified in Item 2 (for legal entity only).**

6. Signature (By)	**7. Title/Relationship *of the Individual if Signing in a Representative Capacity for a legal entity***	**8. Date *(MM-DD-YYYY)***

In accordance with Federal civil rights law and U.S. Department of Agriculture (USDA) civil rights regulations and policies, the USDA, its Agencies, offices, and employees, and institutions participating in or administering USDA programs are prohibited from discriminating based on race, color, national origin, religion, sex, gender identity (including gender expression), sexual orientation, disability, age, marital status, family/parental status, income derived from a public assistance program, political beliefs, or reprisal or retaliation for prior civil rights activity, in any program or activity conducted or funded by USDA (not all bases apply to all programs). Remedies and complaint filing deadlines vary by program or incident.

Persons with disabilities who require alternative means of communication for program information (e.g., Braille, large print, audiotape, American Sign Language, etc.) should contact the responsible Agency or USDA's TARGET Center at (202) 720-2600 (voice and TTY) or contact USDA through the Federal Relay Service at (800) 877-8339. Additionally, program information may be made available in languages other than English.

To file a program discrimination complaint, complete the USDA Program Discrimination Complaint Form, AD-3027, found online at http://www.ascr.usda.gov/complaint_filing_cust.html and at any USDA office or write a letter addressed to USDA and provide in the letter all of the information requested in the form. To request a copy of the complaint form, call (866) 632-9992. Submit your completed form or letter to USDA by: (1) mail: U.S. Department of Agriculture Office of the Assistant Secretary for Civil Rights 1400 Independence Avenue, SW Washington, D.C. 20250-9410; (2) fax: (202) 690-7442; or (3) email: program.intake@usda.gov. USDA is an equal opportunity provider, employer, and lender.

GENERAL INFORMATION ON AVERAGE ADJUSTED GROSS INCOME – PART A

Individuals or legal entities that receive benefits under most programs administered by CCC cannot have incomes that exceed a certain limit set by law. For entities, both the entity itself, and its members cannot exceed the income limitation. If a member, whether an individual or an entity, of an entity exceeds the limitation, payments to that entity will be commensurately reduced according to that member's direct or indirect ownership share in the entity. (All members of the entity must also submit this form to verify income the limitation is met.)

Adjusted Gross Income is the individual's or legal entity's IRS-reported adjusted gross income consisting of both farm and nonfarm income. A three-year average of that income will be computed for the three years of the relevant base period identified on the first page of this form to determine eligibility for the applicable program year. Individuals or legal entities with average **adjusted gross income** greater than $900,000 shall be ineligible for all payments and benefits under the commodity, price support, disaster assistance, and conservation programs.

HOW TO DETERMINE ADJUSTED GROSS INCOME (AGI)

Individual – Internal Revenue Service (IRS) Form 1040 filers, specific lines on that form represent the adjusted gross income and the income from farming, ranching, or forestry operations.

Trust or Estate – the adjusted gross income is the total income and charitable contributions reported to IRS.

Corporation – the adjusted gross income is the total of the final taxable income and any charitable contributions reported to IRS.

Limited Partnership (LP), Limited Liability Company (LLC), Limited Liability Partnership (LLP) or Similar Entity – the adjusted gross income is the total income from trade or business activities plus guaranteed payments to the members as reported to the IRS.

Tax-exempt Organization – the adjusted gross income is the unrelated business taxable income excluding any income from non-commercial activities as reported to the IRS.

HOW TO DETERMINE AVERAGE ADJUSTED GROSS INCOME

The period for calculation of the average AGI will be of the three taxable years preceding the most immediately preceding complete taxable year for which benefits are requested. This table shows examples for applicable years to be used in determining average AGI.

IF the crop year is…	**THEN…** Average AGI will be based on the following years….
2019	2017, 2016, and 2015
2020	2018, 2017, and 2016
2021	2019, 2018, and 2017
2022	2020, 2019, and 2018
2023	2021, 2020, and 2019

GENERAL INFORMATION ON CONSENT TO DISCLOSURE OF TAX INFORMATION – PART B

This consent allows IRS's access to, and use of, certain items of return information to perform calculations, using a methodology prescribed by the USDA, that will assist USDA in its verification of a program participant's compliance with the adjusted gross income (AGI) limitations necessary for participation in, and receipt of, commodity, conservation, price support or disaster program benefits. This consent also permits the USDA to receive certain items of return information for its eligibility determination.

This consent authorizes the disclosure of these items of return information for only the time period specified. Each item of information requested on this form is needed for the IRS to (1) locate, and verify, your tax information; (2) perform the requisite Average AGI calculations; and (3) provide the USDA with the legal entity's name and Taxpayer Identification Number (TIN), the type of return from which the specified items were located for use in the calculation, and whether or not the average AGI is above or below eligibility requirements. The IRS will not provide the USDA with any of the items specified on this consent form that it uses to perform the calculations or the average AGI figure.

This form can only be signed by the person authorized under state law to sign this consent for the legal entity identified in Item 2. ***An approved Power of Attorney (Form FSA-211) on file with USDA cannot be used as evidence of signature authority when completing this form.***

INSTRUCTIONS FOR COMPLETION OF CCC-941

Item No./Field name	Instruction
1. Return Completed Form To	Enter the name and address of the FSA county office or USDA service center where the completed CCC-941 will be submitted.
2. Person or Legal Entity's Name and Address	Enter the person's or legal entity's name and address for commodity, conservation, price support, or disaster program benefits. ***Enter the name and address as it appeared on the IRS tax returns filed for the taxable years specified in Item 4.***
3. Taxpayer Identification Number	In the format provided, enter the complete taxpayer identification number of the person or legal entity identified in Item 2. *This will be either a* ***Social Security Number or Taxpayer Identification Number***.
4. Program Year	Enter the year for which program benefits are being requested. The program year entered determines the 3-year period used for the calculation of the average adjusted gross income (AGI) for payment eligibility and the years for which this consent allows access to tax information.
5. Average Adjusted Gross Income	Select the box next to the response that describes the **average adjusted gross income** for the applicable 3-year period for the program year entered in Item 4. ***Select only one response.***
6. Signature	**Read the acknowledgments, responsibilities and authorizations,** ***before*** **affixing your signature.** ***Power of Attorney (Form FSA-211) on file with USDA cannot be used as evidence of signature authority.***
7. Title/Relationship	Enter title or relationship to the legal entity identified in Item 2.
8. Date	Enter the signature date in month, day and year. ***This form must be returned to FSA within 90 days of the signature date for the consent to be valid.***

EXCEPTION FOR EXCEEDING THE AGI THRESHOLD

There are some farm programs for which the $900,000 AGI limit does not apply if at least 75% of AGI is derived from farming, ranching, or forestry activities. For this purpose, farm AGI is comparable to net income from farming and may be identical to net farm profit (or loss) on Schedule F. The FSA definition of farm AGI also includes income from the sale of farmland, breeding livestock, and agricultural conservation easements. However, the term does not include income derived from the sale of farm equipment or income derived from the sale of production inputs and services. However, if at least two-thirds of total AGI from all sources is from farming, the income from the sale of farm equipment and production inputs and services counts as farm AGI.[217]

In recent years, the market facilitation program (MFP) and the Coronavirus Food Assistance Program (CFAP) are examples of farm programs that do not subject the applicant to a $900,000 AGI limitation.[218] A producer applying for benefits from such a program must certify that the 75% test is satisfied. For this purpose, the FSA might require the producer to sign Form CCC-942, *Certification of Income from Farming, Ranching and Forestry Operations*. Alternatively, a letter from the producer's attorney/CPA can suffice. For entities that apply for benefits, a certification letter is required for the entity and for the individual producer.

Note. The FSA cannot send certifications with respect to the 75% farm AGI test to the IRS for verification.

For purposes of the 75% test, the FSA defines income from farming, ranching, and forestry in a table in the FSA 5-PL, Amendment 6, Para. 312, subparagraph B. The table illustrates that the term is defined broadly.

Wages paid by a farm employer do not constitute farm income. Therefore, if an applicant's only income is from wages earned via employment with a farming C corporation, the wages do not count as farm income for purposes of the 75% test. This is only an issue if the producer/applicant's income is over the $900,000 threshold.

The FSA regulations and associated guidance do not address whether income from a farmer's foreign sales that are funneled through an interest charge domestic international sales corporation (IC-DISC) counts as farm income for purposes of the 75% test. An IC-DISC allows a farmer that sells into an export market to essentially transfer income from the farmer to the tax-exempt IC-DISC via an export sales commission. An IC-DISC can be formed and utilized by any taxpayer that manufactures, produces, grows, or extracts property in the United States that is held primarily for sale, lease, or rental in the ordinary course of the taxpayer's trade or business. That definition certainly includes farmers. The property to be exported is transferred to the IC-DISC which then sells the assets into an export market. While there is no official guidance on the issue, it would seem reasonable that such income counts as farm income.

217. FSA 5-PL, Para. 312, subparagraph F.

218. *Agricultural Act of 2014,* PL 113-79, §1605.

This form is available electronically.

OMB No. 0560-0292
OMB Expiration Date: 04/30/2022

CCC-942 (05-19-20) U.S. DEPARTMENT OF AGRICULTURE Commodity Credit Corporation	1. PROGRAM YEAR:
CERTIFICATION OF INCOME FROM FARMING, RANCHING AND FORESTRY OPERATIONS	2. Return completed form to *(Name and address of FSA county office or USDA Service Center)*:

NOTE: *The following statement is made in accordance with the Privacy Act of 1974 (5 USC 552a – as amended). The authority for requesting the information identified on this form is Sec. 5 of the Commodity Credit Corporation Act [15 U.S.C. 714 et seq]. The information will be used to determine eligibility for program benefits. The information collected on this form may be disclosed to other Federal, State, Local government agencies, tribal agencies, and nongovernment entities that have been authorized access to the information by statue or regulation and/or as described in applicable Routine Uses identified in the System of Records Notice for USDA/FSA-2, Farm Records File (Automated).*

Public Burden Statement (Paperwork Reduction Act): *Public reporting burden for this collection is estimated to average 5 minutes per response, including reviewing instructions, gathering and maintaining the data needed, completing (providing the information), and reviewing the collection of information. You are not required to respond to the collection or FSA may not conduct or sponsor a collection of information unless it displays a valid OMB control number.* ***RETURN THIS COMPLETED FORM TO YOUR COUNTY FSA OFFICE.***

3. Name and Address of Individual or Legal Entity *(Including Zip Code)* *(If general partnership or joint venture, complete only for each member)*	4. Last (4) Digits - Taxpayer Identification Number *(TIN)* *(Social Security Number for Individual; or Employer Identification Number for Legal Entity*

PART A – CERTIFICATION OF FARM INCOME

5. Individuals and Legal Entities exceeding the $900,000 AGI limitation may otherwise qualify for certain program benefits, when the program authorizes the individual or legal entity to qualify based on following conditions:

- at least 75 percent of the individual's or legal entity's average adjusted gross income (AGI) for the 3 taxable years preceding the most immediately preceding complete taxable year was derived from farming, ranching or forestry operations. For example, if the program year is 2019, then the 3-year period for the calculation will be the taxable years of 2017, 2016 and 2015.
- a certification from a licensed CPA or an attorney is submitted to the FSA/USDA Service Center identified in Item 2, attesting that at least 75 percent of the individual's or legal entity's average AGI for the 3 taxable years preceding the most immediately preceding complete taxable year was derived from farming, ranching, or forestry operations. The CPA or Attorney may meet this requirement by completing Part C below or providing a similar statement that is acceptable to FSA.

PART B – CERTIFICATION BY INDIVIDUAL OR ENTITY

By signing this form:

- *I acknowledge the average AGI for the applicable program year exceeds the $900,000 statutory AGI limitation for the individual or legal entity identified in Item 3.*
- *I acknowledge that I have read and reviewed all definitions and requirements on Page 2 of this form;*
- *I certify that all information contained in a certification from a CPA or attorney is true and correct, and is consistent with the tax returns filed with the IRS for myself or the legal entity that is seeking to qualify for program benefits subject to a certification of farm income;*
- *I acknowledge that failure to provide the certification referenced in Part A to FSA will result in being ineligible for the applicable program benefit;*
- *I certify that I am authorized under applicable state law to sign this certification on behalf of the legal entity identified in Item 3 (for legal entity only).*

6. Signature (By)	7. Title/Relationship of the Individual if Signing in a Representative Capacity	8. Date *(MM-DD-YYYY)*

PART C – CERTIFICATION BY CERTIFIED PUBLIC ACCOUNTANT / ATTORNEY

By signing this form:

- *I acknowledge that I have read and reviewed all definitions and requirements on Page 2 of this form;*
- *I certify the producer identified in Items 3 and 4 has met the minimum requirements specified in Part A for the program year identified in Item 1.*

9. Signature	10. Title *(CPA/Attorney)*	11. State/License Number	12. Date (*MM-DD-YYYY)*

CCC-942 (05-19-20) Page 2 of 2

HOW TO DETERMINE ADJUSTED GROSS INCOME

Adjusted Gross Income (AGI) is the individual's or legal entity's IRS-reported adjusted gross income or equivalent (see below) consisting of both farm and nonfarm income.
Individual – Internal Revenue Service (IRS) Form 1040 filers, specific lines on that form represent the adjusted gross income
Trust or Estate – the adjusted gross income equivalent is the total income and charitable contributions reported to IRS
Corporation – the adjusted gross income equivalent is the total of the final taxable income and any charitable contributions reported to IRS
Limited Partnership (LP), Limited Liability Company (LLC), Limited Liability Partnership (LLP) or Similar Entity – the adjusted gross income is the total income from trade or business activities plus guaranteed payments to the members as reported to the IRS
Tax-exempt Organization – the adjusted gross income is the unrelated business taxable income excluding any income from non-commercial activities as reported to the IRS.

HOW TO DETERMINE INCOME FROM FARMING, RANCHING, AND FORESTRY OPERATIONS

Income received or obtained from the following sources:

Production of crops, specialty crops, and raw forestry products.	*Feeding, rearing, or finishing of livestock.*
Production of livestock, aquaculture products used for food; honeybees; and products produced by or derived from livestock.	*Payments of benefits, including benefits from risk management practices, crop insurance indemnities, and catastrophic risk protection plans.*
Production of farm-based renewable energy.	*Sale of land that has been used for agricultural purposes.*
Sale, including easements and development rights, of farm, ranch, and forestry land, water or hunting rights, or environmental benefits.	*Payments and benefits authorized under any program made available and applicable to payment eligibility and payment limitation rules.*
Rental or lease of land or equipment used for farming, ranching, or forestry operations, including water or hunting rights.	*Any other activity related to farming, ranching, and forestry, as determined by the Deputy Administrator of FSA.*
Processing, packing, storing, and transportation of farm, ranch, forestry commodities including renewable energy.	*Any income reported on Schedule F or other schedule used by the person or legal entity to report income from such operations to the IRS.*

Note: Income from wages or dividends (except IC-DISC dividends derived from farm, ranch or forestry activities) earned through a farming operation is NOT farm income.

HOW TO DETERMINE PERCENTAGE OF AVERAGE AGI FROM FARMING, RANCHING, AND FORESTRY OPERATIONS

1) Determine the total AGI and the total income from farming, ranching, and forestry for each of the 3 taxable years preceding the most immediately preceding complete taxable year for which benefits are requested.
2) Total the AGI (both farm and nonfarm income) from all 3 years.
3) Total the income from farming, ranching and forestry from all 3 years.
4) Calculate the percentage of average adjusted gross farm income by dividing the result of step 3 by the result of Step 2. The percentage calculated must be equal to; or greater than 75 percent to qualify for program benefits.

This form can only be signed by the individual authorized under state law to sign as a representative of the legal entity identified in Item 3.

INSTRUCTIONS FOR COMPLETION OF CCC-942

Item No./Field name	Instruction(s)
1. Program Year	Enter the year for which program benefits are being requested. The program year entered determines the 3-year period used for the calculation of the average adjusted gross income (AGI) for payment eligibility.
2. Return Completed Form To	Enter the name and address of the FSA county office or USDA service center where the completed CCC- 942 will be submitted.
3. Individual or Legal Entity's Name and Address	Enter the individual's or legal entity's name and address.
4. Taxpayer Identification Number	Enter the <u>Last 4 Digits of the</u> taxpayer identification number for the individual or legal entity identified in Item 3.
5. Signature	Read the acknowledgments, responsibilities and authorizations, *before* signing. (*INDIVIDUAL OR ENTITY*)
6. Title/Relationship	Enter title or relationship to the legal entity identified in Item3.
7. Date	Enter the signature date in month, day and year.
8. Signature	Read the acknowledgments, responsibilities and authorizations, before signing. (*CPA or Attorney Only*).
9. Title	Identify Certified Public Accountant (CPA) or Attorney as applicable.
10. State/License Number	Enter applicable State the CPA or attorney is licensed to practice in, followed by the associated individual license number.
11. Date	Enter the signature date in month, day and year.

DEFERRED PAYMENT CONTRACTS FOR SALES OF AGRICULTURAL COMMODITIES

GENERAL RULE

A cash-basis taxpayer accounts for income in the tax year that it is either actually or constructively received. The constructive receipt doctrine is the primary tool that the IRS uses to challenge deferral arrangements. A taxpayer is deemed to have constructively received income when **any of the following** occur.[219]

- The income was credited to the taxpayer's account.
- The income was set apart for the taxpayer.
- The income was made available for the taxpayer to draw upon it, or it could have been drawn upon if notice of intent were given, unless the taxpayer's control of the receipt of the income is subject to substantial limitations or restrictions.

However, income received under a properly structured deferred payment contract is taxed under the installment payment rules.[220]

DEFERRAL ARRANGEMENTS

The most likely way for a farmer to avoid an IRS challenge of a deferral arrangement is for the farmer to enter into a sales contract with a buyer that calls for payment in the next tax year. This type of contract simply involves the buyer's unsecured obligation to purchase the agricultural commodities from the seller on a particular date. Under this type of deferral contract, the price of the goods is set at the specified time for delivery, but payment is deferred until the next year. If the contract is bona fide and entered into at arm's length, the farm seller has no right to demand payment until the following year. Additionally, if the contract (as well as the sale proceeds) is nonassignable, nontransferable, and nonnegotiable, the deferral will not be challenged by the IRS.

The following criteria for a deferred payment contract should be met in order to successfully defer income to the following year.

- The seller should obtain a written contract that, under local law, binds both the buyer and the seller. A note should not be used.
- The contract should state clearly that under no circumstances would the seller be entitled to the sales proceeds until a specific date (i.e., a date in a future tax year). The earliest date depends on the farmer's tax yearend.
- The contract should be signed before the seller has the right to receive any proceeds, which is normally before delivery. That means that the contract should have been executed before the first crop delivery. If the contract was not executed until after the crop proceeds were delivered, the IRS can argue that the farmer actually had the right to the income, but later chose not to take possession of it until the next tax year. An oral agreement to the contrary can be difficult to prove.
- The buyer should not credit the seller's account for any goods the seller may want to purchase from the buyer during the year of the deferred payment contract (such as seed and/or fertilizer). Instead, such transactions should be treated separately when billed and paid.
- The contract should state that the taxpayer has no right to assign or transfer the contract for cash or other property.
- The contract should include a clause that prohibits the seller from using the contract as collateral for any loans or receiving any loans from the buyer before the payment date.

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219. Treas. Reg. §1.451-2(a).

220. IRC §§453(b)(2) and 453(l)(2)(A).

- The buyer should avoid sales through an agent (such as a livestock sale barn) in which the agent merely retains the proceeds. Receipt by an agent usually is construed as receipt by the seller for tax purposes.
- Price-later contracts (in which the price is set in a later year) should state that no payment can be received prior to the designated date, even if a price is established earlier.
- The contract may provide for interest. Interest on an installment sale is reported as ordinary income in the same manner as any other interest income. Contracts that lack these specific parameters run the risk of subjecting the seller to the constructive receipt rules with income recognition in the year of delivery. Simply delivering the grain under a contract where the grain is credited to an open account with a delay in payment until proper accounting for grain deliveries and other required administrative steps have occurred will not likely be enough to avoid an IRS assertion of constructive receipt. It may not matter much to the IRS that the farmer-seller is subject to administrative and processing delays and, as a result, cannot actually receive payment until the next tax year. The deferred payment contract must be in the **proper form.** A contract that states that payment is deferred until the next tax year and that it constitutes a voluntary extension of credit by the seller coupled with language stating that it can be changed in writing by the buyer's authorized agent invites IRS scrutiny upon the integrity of the deferral arrangement.

Caution. It is not suggested that a farmer utilize a single contract and then claim that each delivery is a separate sale for purposes of electing out of IRC §453. The IRS could easily take the position that such a contract involves a sale of everything (all the grain) because the farmer-seller has given the buyer the ability to buy everything in year 1. The farmer lost control in year 1 — the buyer has the power to take the grain in year 1. The contract is letting the buyer determine the year 1 tax consequences to the seller. The election out of installment reporting is by the seller (taxpayer) not the buyer. The proper approach is to have multiple deferred payment contracts with the seller determining whether to report the income under the contract in the current year (electing out of installment reporting) or not on a contract-by-contract basis. When the taxpayer tries to do this on a delivery-by-delivery basis under a single contract, the taxpayer is no longer making the election... the buyer is.

Security for Payment

After an agricultural commodity is delivered to the buyer but before payment is made, the seller is an unsecured creditor of the buyer. To provide greater security for the transaction, a farmer-seller may use letters of credit or an escrow arrangement. This could lead to a successful challenge by the IRS on the basis that the letters of credit or the escrow can be assigned, with the result that deferral is not accomplished.

Although the general rule is that funds placed in escrow as security for payment are not constructively received in the year of sale, it is critical for a farmer-seller to clearly indicate that the buyer is being looked to for payment and that the escrow account serves only as security for this payment.[221] In addition, any third-party guarantee or standby letter of credit should be nonnegotiable and established so that it can only be drawn upon in the event of default. If the escrow account is properly created, the funds held in escrow and the accrued interest on those funds is taxable as income in the year that it provides an economic benefit to the taxpayer.

Note. Further complicating the issue is the fact that deferred payment sales are usually not covered by state bonding requirements or state indemnity funds that apply to cover the costs to grain producers on failure of an elevator. Thus, before entering into a deferred payment or installment sales contract, the seller should have confidence in the purchaser's financial stability. If the purchaser is unable to pay at a later date, the farmer or rancher may receive little or nothing due to no recourse from state regulators.[222]

221. Case law pertaining to letters of credit or escrow accounts used in the context of deferral arrangements includes the following: *Watson v. Comm'r,* 613 F.2d 594 (5th Cir. 1980); *Griffith v. Comm'r,* 73 TC 933 (1980); *Reed v. Comm'r,* 723 F.2d 138 (1st Cir. 1983); *Busby v. Comm'r,* 679 F.2d 48 (5th Cir. 1982); *Scherbart v. Comm'r,* 453 F.3d 987 (8th Cir. 2006).

222. See, e.g., *KPMG Peat Marwick v. Asher,* 689 N.E.2d 1283 (Ind. Ct. App. 1997) (accounting firm owed no duty to farmers who lost substantial sums on grain sold on credit to elevator when elevator filed bankruptcy before paying for stored grain. Farmers did not inquire into financial status of elevator before sale and did not rely on accounting firm's audit of elevator).

Use of a Third Party

It is possible to utilize a deferral arrangement by using a third party such as a broker or cooperative. In that event, agency principles are important in determining whether the farmer-seller is held to be in constructive receipt of the sale proceeds in the year in which the arrangement is initiated. Indeed, with respect to deferral arrangements involving livestock, the IRS takes the position that livestock sales under the Packers and Stockyards Act are consignment contracts that create an agency relationship.[223]

Tax Planning

For deferred sales that are structured properly and achieve income tax deferral, installment reporting is automatic unless the taxpayer makes an election not to use it. An installment sale is a sale of property with the taxpayer receiving at least one payment after the tax year of the sale.[224] Thus, if a farmer sells and delivers grain in one year and defers payment until the next year, that transaction constitutes an installment sale. If desired, the farmer can elect out of the installment-sale method on a contract-by-contract basis and report the income in the year of sale and delivery.

The election must be made by the due date, including extensions, of the tax return for the year of sale and not the year in which payment is to be received. The election is made by simply recognizing the entire gain on the taxpayer's applicable form (i.e., Schedule F, Form 4835, Schedule D, *Capital Gains and Losses*, or Form 4797), rather than reporting the installment sale on Form 6252, *Installment Sale Income.*

Because of the all-or-nothing feature (on a per-contract basis) of electing out of installment reporting, it may be advisable for farm taxpayers to utilize multiple deferred payment sales contracts in order to better manage income from year to year.

Example 8. Farmer Brown raised 100,000 bushels of grain in 2020. He sells 50,000 bushels at harvest and enters into five 10,000-bushel deferred payment contracts due January 5, 2021 at $7.50 per bushel. When CPA Smith prepares the 2020 return (to be filed by March 1, 2021), she determines that instead of having desired farm income of $75,000, the actual income is zero. Farmer Brown thus elects to accelerate one of the contracts worth $75,000 into 2020 increasing his income to the desired $75,000 level.

However, if instead of entering into five contracts, assume Farmer Brown enters into one contract. When CPA Smith informs him that his income is zero, Farmer Brown has limited flexibility to increase his income. He can either show farm income of zero or accelerate $375,000 of the deferred payment income into 2020. Neither is the desired result.

The election out is made by simply reporting the taxable sale in the year of disposition. But, when the election out of the installment method is made by reporting the income in the year of the sale, the seller must be careful to ensure that the gain recognized in that year is also not recognized in the following year.

Practitioner Planning Tip

To optimize gross receipts per quarter and qualify for ERC, it is possible some farm taxpayers may have utilized deferral arrangements during 2021. Tax practitioners should ask their clients if they engaged in any such arrangements.

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223. Rev. Rul. 70-294, 1970-1 CB 13. However, one court held that a deferral arrangement involving the sale of livestock was effective despite the PSA provision because the arrangement imposed "substantial qualifications and restrictions" that defeated constructive receipt and amounted to a substantial limitation. *Levno v. U.S.,* 440 F. Supp, 8 (D. Mont. 1977).

224. IRC §453(b)(7).

Generally, if the taxpayer elects out of the installment method, the amount realized at the time of sale is the proceeds received on the sale date and the FMV of the installment obligation (future payments). If the installment obligation is a fixed amount, the full principal amount of the future obligation is realized at the time of the acquisition.

Practitioner Planning Tip

With potential for increases in future tax rates, electing out of installment treatment by reporting income in the current year might make sense. Future payments would only be taxable to the extent of interest received. Entering into the deferred payment contract creates risk in the event of buyer default. In addition, accelerating income may have other impacts on the taxpayer's return.

Untimely Death of Seller

If a seller dies before receiving all the payments under an installment obligation, the installment payments are treated as income in respect of a decedent (IRD).[225] Therefore, the beneficiary does not receive a stepped-up basis at the seller's death. The beneficiary of the payments includes the gain on the beneficiary's return subject to their tax rate. The character of the payments is tied to the seller. Consequently, if the payments were long-term capital gain to the seller, they are long-term capital gain to the beneficiary.

Note. Grain farmers often carry a large inventory that may include grain delivered under a valid deferred payment agreement. Grain included as inventory but more properly classified as an installment sale will not qualify for stepped-up basis if the farmer dies after delivering the grain but before receiving all payments.

The only way to avoid possible IRD treatment on installment payments appears to be for the seller to elect out of installment sale treatment. IRD includes sales proceeds "to which the decedent had a contingent claim at the time of his death."[226] The courts have held that the appropriate inquiry regarding installment payments is whether the transaction gave the decedent at the time of death the right to receive the payments.[227] This means that the decedent holds a contingent claim at the time of death that does not require additional action by the decedent. In that situation, the installment payments are IRD.

225. IRC §691(a)(4).

226. Treas. Reg. §1.691(a)-1(b)(3).

227. See e.g., *Estate of Bickmeyer v. Comm'r,* 84 TC 170 (1985).

Practitioner Planning Tip

With potential for increased future tax rates, the seller electing out of installment treatment might make sense. Electing out of installment treatment will cause full recognition of the contract gain in the year of sale.[228] Therefore, in future years as payments are received, only the interest portion received will constitute taxable income. Making the election does create risk for the seller in the event the buyer should default on the contract. In addition, the increased income reporting in the current year may impact the taxpayer's access to other income-based credits and deductions. For more information on installment sales and procedure for electing out of installment sale treatment, see the 2017 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: Installment Sales. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

IRS Guide

Chapter 9 of the IRS Farmers Audit Technique Guide (ATG) provides a summary of income deferral and constructive receipt rules.[229] The ATG provides a procedural analysis for examining agents to use in evaluating deferred payment arrangements.

Note. At the time this workbook went to press, the ATG had recently been pulled from the IRS website for revisions, with no available timetable for republication.

CURRENT DEVELOPMENTS: CONSERVATION EASEMENTS

The donation of a permanent conservation easement on farm or ranch land can provide a significant tax benefit to the donor. The donor can receive an income tax deduction equal to the FMV of the contributed conservation easement at the time of the donation;[230] an estate tax benefit at death by excluding the FMV of the donated easement from the donor's (landowner's) gross estate;[231] and a possible reduction in property taxes (dependent on state law). In addition, during life, the donor retains the right to sell or transfer the property subject to the easement restrictions.

Note. The rules are complex, frequently challenged, and must be carefully complied with to obtain the tax benefits that are possible — qualified farmers and ranchers can deduct up to 100% of their income (i.e., the contribution base).[232] For others, the limit is 50% of annual income.[233]

228. IRC §453(d); See IRS Pub. 537, *Installment Sales*.
229. *Farmers (ATG) Chapter Nine — Grain.* Aug. 2009. IRS. [www.irs.gov/pub/irs-utl/farmers_atg_chapter_9.pdf] Accessed on Aug. 30, 2021.
230. IRC §170(h); Treas. Reg. §1.170A-14.
231. IRC §2031(c)(1)-(2).
232. IRC §170(b)(1)(E)(iv)(I).
233. IRC §170(b)(1)(B).

OVERVIEW

The donation of a permanent conservation easement is accomplished via a transaction that involves a legally binding agreement that is voluntarily entered into between a landowner and qualified charity — some form of land trust or governmental agency. Under the agreement, the landowner allows a permanent restriction on the use of the donated land to protect conservation characteristics associated with the tract.[234] All the applicable tax rules must be precisely complied with in order to generate a tax deduction. This is one area of tax law where a mere "foot-fault" can be fatal.

IRS CONCERNS

The key to securing a tax deduction for the donation of a permanent conservation easement is the proper drafting of the easement deed (as well as an accurate and detailed appraisal of the property). That is the instrument that conveys the legal property interest of the easement to the qualified charity (qualified land trust, etc.). This document must be drafted very precisely. For example, the donor must not reserve rights that are conditioned upon the donee's consent. This is termed a **deemed consent provision** and it will cause the donated easement to fail to be a perpetual easement — one of the requirements to get a charitable contribution deduction.[235]

The IRS also takes the position that the perpetuity requirement is not met if a mortgage on the property is not subordinated. For instance, in *Palmolive Building Investors, LLC v. Comm'r,*[236] a charitable deduction was denied because the mortgages on the property were not subordinated to the donated façade easements as Treas. Reg. §1.170A-14(g)(2) requires. In addition, the deed at issue stated that the mortgagees had prior claims to extinguishment proceeds. That language violated the requirement set forth in Treas. Reg. §1.170A-14(g)(6)(ii). A savings clause in the deed did not cure the defective language because the requirements of IRC §170 must be satisfied at the time the easement is donated.

The caselaw also supports the IRS's position that development rights and locations for development cannot be reserved on the property subject to the easement if it changes the boundaries for the easement. The IRS's position is that the easement deed language must place a perpetual encumbrance on specifically defined property that is fixed at the time of the grant. However, if the easement only allows the boundary of potential development to be changed on a portion of a larger parcel that is subject to the easement restrictions and neither the acreage of potential development nor the easement is enhanced, the perpetuity requirement remains satisfied.[237]

Another problem with easement deeds that the IRS evaluates is whether the deed language allows the donor and donee to mutually agree to amend the deed. If this reserved right is present, the IRS takes the position that the easement is not perpetual in nature and does not satisfy the perpetuity requirement of §170(h)(2)(C). However, there is an exception. Amendment language is allowed if any subsequent transfer by the donee, via amendment language in the deed, facilitates the conservation purpose of the original transfer to the donee organization.[238]

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234. IRC §170(h); Treas. Reg. §1.170A-14.

235. See Treas. Regs. §§1.170A-14(e)(2), 1.170A-14(g)(1), and 1.70A-14(g)(6)(ii).

236. *Palmolive Building Investors, LLC v. Comm'r,* 149 TC 380 (2017).

237. See e.g., *Bosque Canyon Ranch II, L.P. v. Comm'r,* 867 F.3d 547 (5th Cir. 2017); Treas. Reg. §1.170A-14(f).

238. Treas. Reg. 1.170A-14(c)(2); see also *Butler v. Comm'r,* TC Memo 2012-72 (Mar. 19, 2012).

EXTINGUISHMENT REGULATION

Another requirement of securing a charitable deduction for a donated conservation easement is that the charity must be absolutely entitled to receive a portion of any proceeds received from condemnation or casualty or any other event that terminates the easement.[239] This is required because of the perpetual nature of the easement. However, exactly how the allocation is computed is difficult to state in the easement deed. The basic point is that the allocation formula cannot result in what a court (or IRS) could deem to be a windfall to the taxpayer.[240] In addition, the allocation formula must be drafted so that it does not deduct from the proceeds allocable to the donee an amount that is attributable to **improvements** that the donor makes to the property after the donation of the permanent easement. If such a reduction occurs, the IRS presently takes the position that no charitable deduction is allowed because the specific requirements of the proceeds allocation formula are not satisfied.

Note. This seems counter-intuitive but it is an IRS audit issue with respect to donations of permanent conservation easements.

If the donee acquires the fee simple interest in the real estate that is subject to the easement, the donee's ownership of both interests would merge under state law and thereby extinguish the easement. This, according to the IRS regulations, would trigger a violation of the perpetuity requirement. Consequently, deed language may be included to deal with the merger possibility. However, such language is problematic if it allows the donor and donee to contractually agree to extinguish the easement without a court proceeding. Leaving merger language out of the easement deed would seem to result in the IRS not raising the merger argument until the time (if ever) the easement interest and the fee interest actually merge.

Litigation on Extinguishment Regulation

The Tax Court has decided a couple of cases recently involving the extinguishment regulation. In *Oakbrook Land Holdings, LLC v. Comm'r,*[241] various investors created Oakbrook Land Holdings in 2007 and bought 143 acres on a mountain near Chattanooga, Tennessee for $1.7 million. The following year, the petitioner donated 106 acres to a qualified land trust as a permanent conservation easement and claimed a $9.5 million 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 for violating the extinguishment regulation of Treas. Reg. §1.170A-14(g)(6) because the qualified land trust was not entitled to a proper proportionate share of proceeds if the easement were acquired through eminent domain at some future date. On the contrary, the easement language in the deed had the effect of allocating to the petitioner all the value of any land improvements made after the easement was donated. The full Tax Court agreed with the IRS's position on the allocation issue, and also upheld the validity of the regulation on the basis that the extinguishment regulation had been properly promulgated and did not violate the Administrative Procedure Act (APA). 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.*[242]

239. Treas. Reg. §1.170A-14(g)(6).

240. See e.g., *PBBM-Rose Hill, Ltd. v. Comm'r,* 900 F.3d 193 (5th Cir. 2018); *Carroll v. Comm'r,* 146 TC 196 (2016).

241. *Oakbrook Land Holdings, LLC v. Comm'r,* 154 TC 180 (2020).

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

Note. In a related memorandum opinion, *Oakbrook Land Holdings, LLC v. Comm'r,*[243] 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 by the ratio of the FMV of the easement to 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.

The Tax Court again upheld its proportionate value approach in a case in which the deed granting the easement reduced the donee's share of the proceeds in the event of extinguishment by the value of improvements (if any) that the donor made.[244] As such, the petitioner had not satisfied the perpetuity requirement of §170(h)(5)(A). The Tax Court upheld the validity of the regulation and the petitioner's claimed deduction was denied.

Litigation at the Appellate Court Level

The petitioner in the *Oakbrook* case has appealed the Tax Court's opinion to the U.S. Circuit Court of Appeals for the Sixth Circuit, claiming that the Treasury violated the APA in creating the extinguishment regulation by not soliciting comments and failing to reasonably interpret the underlying statute. The petitioner latched onto Judge Holmes' dissent in the full Tax Court opinion, that determined that the IRS had not properly considered public comments as the APA required. Judge Holmes viewed the majority interpretation as having the future effect of denying many more charitable deductions associated with conservation easements. The petitioner is also claiming on appeal that the deed language satisfied the perpetuity requirement, and that the petitioner should not be liable to "predict and compensate the donee for hypothetical events outside of the donor's control." The petitioner is also claiming that the IRS's arguments concerning the deed language relating to the perpetuity requirement were not raised at the Tax Court level and should be barred on appeal. The petitioner also claims that the deed language has been commonly used for over 30 years and, as such, the current IRS's position is contrary to the Congressional purpose of the statute to incentivize conservation uses of land.

In another case involving the extinguishment regulation, the U.S. Court of Appeals for the Eleventh Circuit denied a $6.9 million deduction associated with a donated conservation easement. In *TOT Property Holdings, LLC v. Comm'r,*[245] the petitioner engaged in a syndicated easement transaction whereby it made a $6.9 million charitable contribution for an easement on 637 acres of a 652-acre parcel donated to a land conservancy. The IRS denied a charitable deduction due to the easement deed not satisfying the perpetuity requirement and imposed a 40% gross valuation misstatement and negligence penalties. The Tax Court agreed and determined that the actual value of the easement donation was less than 10% of what was originally reported on the petitioner's return. In the process, the Tax Court gave more credibility to the approach of the appraiser for the IRS.

243. *Oakbrook Land Holdings, LLC v. Comm'r,* TC Memo 2020-54 (May 12, 2020).

244. *Smith Lake, LLC v. Comm'r,* TC Memo 2020-107 (Jul. 13, 2020).

245. *TOT Property Holdings, LLC v. Comm'r,* No. 20-11050, 2021 U.S. App. LEXIS 18679 (11th Cir. Jun. 23, 2021), *aff'g* No. 5600-17 (U.S. Tax Court Dec. 13, 2019).

On appeal, the appellate court affirmed the denial of the deduction and the penalties that the IRS imposed, including a 40% gross valuation misstatement penalty. The appellate court also noted that the deed in question would subtract any gain in value from improvement to the land after the donation if the easement were extinguished by judicial action. That, the appellate court noted, violated the formula set forth in the extinguishment regulation[246] and contained an unenforceable savings clause. The appellate court also dismissed the petitioner's expert opinion that the best use of the easement before the donation was as residential development because the evidence showed that the surrounding areas were unpopulated and undeveloped. As such, the appellate court determined that the Tax Court reasonably concluded that the easement's most valuable use would have been as a recreation and timber investment property.

Note. Pending the outcome of the Sixth Circuit's decision in *Oakbrook Land Holdings, LLC*, the U.S. Supreme Court could be asked to address issues involving the extinguishment regulation.

In Chief Counsel Advice 202130014,[247] the IRS provided sample deed language for complying with the extinguishment regulation that would not cause the deed to violate the **enforceability in perpetuity** requirement. The IRS sample language reads as follows.

> *Donor agrees that the donation of the perpetual conservation restriction described in this deed gives rise to a property right, immediately vested in the donee organization, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction, at the time of the gift, bears to the fair market value of the property as a whole at that time. For purposes of this paragraph, the proportionate value of the donee organization's property rights shall remain constant.*
>
> *On a subsequent sale, exchange or involuntary conversion of the subject property, the donee organization will be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction.*
>
> *All of the donee organization's proceeds from a subsequent sale or exchange of the property must be used by the donee organization in a manner consistent with the conservation purposes of the original contribution.*

DEVELOPMENTS IN THE U.S. TAX COURT

TEAM ROPING ACTIVITY GETS LASSOED FOR NO PROFIT INTENT[248]

Facts. The petitioner was engaged in the insurance business when he began devoting a large part of his time to team roping. He lost tens of thousands of dollars roping, some of which he reported on the same Schedule C that he reported income and loss for his insurance business. The IRS disallowed the losses as personal expenses. The petitioner began competitive team roping in 1989 as a header. In 2009, he began reporting income and loss from roping on Schedule C when he decided to make it his business. His business plan was to "get better" by winning more competitions and to also by sell and breed team-roping horses. He purchased a mare (for the sole purpose of breeding), a saddle, and a luxury horse trailer complete with living quarters. He lost over $50,000 in each year from 2009–2011 on the team roping activity, which he used to offset his income from the insurance business. The petitioner did not maintain a separate bank account or records for the team roping activity and did not keep a budget for it.

Position of the IRS. The petitioner claimed that he had a profit intent for the team roping activity. The IRS disagreed, noting that it was highly improbable that the petitioner could ever have a genuine profit motive.

246. Treas. Reg. §1.170A-14(g)(6)(ii).

247. CCA 202130014 (Jun. 16, 2021).

248. *Gallegos v. Comm'r,* TC Memo 2021-25 (Mar. 2, 2021).

Tax Court's Analysis. The Tax Court used the nine factors of Treas. Reg. §1.183-2(a) to determine if a profit intent was present based on the facts and circumstances. The Tax Court noted that the petitioner did not conduct the team roping activity in a business-like manner; lacked practical knowledge of team roping economics; did not spend sufficient hours in the activity to disrupt his insurance business; had no realistic expectation that the horses would appreciate in value; failed to show that the insurance business experience aided him in the team roping activity; never profited from the activity and used the losses to offset his insurance business income; made large investments in the team roping activity but failed to make much money at it; was independently wealthy; and received a lot of personal pleasure or recreation from the team roping activity.

Accordingly, the Tax Court held that the petitioner did not engage in the team roping activity with the primary motivation to earn a profit and denied the deductions for the tax years at issue associated with the team roping activity.

ALL HAT. NO CATTLE. NO DEDUCTION.[249]

Facts. The petitioner was retired from the banking industry. In 2003, before he retired, he purchased for $350,000 a 156-acre tract that had been a timber farm and cattle operation. Out of the entire tract, 134 acres were comprised of timber. It was not an active timber or farming operation when he bought it. However, the land was in the Conservation Reserve Program (CRP). In 2004, he bought an additional 26 contiguous acres. That tract included a new (built in 2000) home along with a barn and a small caretaker's house.

On the advice of his long-time CPA, the petitioner created an LLC in 2004. He owned 97% of the LLC, his wife was a 1% owner, and their children owned the balance. He never transferred the land to the LLC. For several years, he spent about 700 hours annually maintaining the property without any formal business plan. There was no harvesting of timber due to the land being in the CRP. The petitioner would occasionally thin the trees to allow sunlight to get through to aid the growth of pine trees which would be harvested after many years of growth. The petitioner testified that he had wanted to introduce cattle "from day one." He had consulted with two cattle experts for advice but he could not remember when the consultations had occurred or what he had learned from those experts. The petitioner did not have cattle on the property until at least 2008 — soon after he learned that he was going to be audited. He also testified that many of what he claimed to be cattle-related activities were preparatory activities so that cattle could be on the property at some future date. Those preparatory activities included the installation of fencing and barn repairs.

The petitioner ran the LLC very informally, keeping no traditional accounting records such as ledgers, balance sheets, income statements, or cash flow statements. He did not expense the cost of insurance for the property and did not maintain a separate bank account or any separate banking records during the years at issue. For those years, the petitioner filed Form 1065 stating that the LLC's principal business activity was a "Farm" and the principal product or service was "Cattle." This was also how the activity was characterized on the petitioner's Schedule F. The petitioner's tax returns were professionally prepared by the petitioner's CPA, even though the petitioner had a "cattle farm" with no cattle, and a "tree farm" with no timber. He showed a tax loss from the property for tax years 2004–2008 on Schedule F, with the losses stemming largely from depreciation claimed on two buildings on the property.

Position of the IRS. The IRS notified the petitioner in early 2008 that it was going to audit the LLC for tax year 2005. Upon receiving the audit notice, the petitioner put together a forest management plan and brought cattle to the property. The IRS later expanded the audit to include tax years 2004 and 2006–2008. The IRS disallowed the losses on the basis that the petitioner's activity on the land was not engaged in with a profit intent. The IRS also disallowed a large charitable deduction for the petitioner's deduction of a permanent conservation easement.

Tax Court's Analysis. The Tax Court agreed with the IRS, finding that all nine factors of the Treas. Reg. §1.183-2(a) favored the IRS. This was despite the Tax Court's recognition that the facts suggested that the petitioner was attempting to transform the property into a viable farming business.

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249. *Whatley v. Comm'r,* TC Memo 2021-11 (Jan. 28, 2021).

FIVE STRIKES — YOU'RE OUT[250]

Facts. The petitioners, a married couple, were residents of California. The wife conducted a farming operation in Mexico for which she reported a net loss on Schedule F for every year from 2007 to 2014. She began raising chickens to sell for meat in 2007. However, she could not recall selling any of the chickens through 2011 and only had one sale of anything during that timeframe — a $264 loss on the resale of livestock. She switched to raising chickens for egg production but soon determined that the venture would not be profitable due to an increased cost of feed. She sold what eggs had been produced for $1,068 and switched back to selling chickens for meat in 2012. She did not sell any chickens in 2012 or 2013 and her plan to begin selling chickens in 2014 was thwarted when the flock was destroyed by wild dogs.

During 2007–2011, she attempted to grow various fruits and vegetables, but the activity was discontinued because the soil was not capable of production due to a nearby salt flat. As a result, she had no sales revenue, only expenses that she deducted. She tried to grow peppers in 2012 but insects destroyed the crop and there was no marketable production. Later that year, she acquired three cows and three calves in hopes to "make the calves big, sell them, impregnate the mothers… repeat." She had to sell the cows in 2013 for $4,800 because there was insufficient forage on the 6,500-acre tract. The $4,800 was the only farm activity income reported for 2013. In 2012 and 2013, the taxpayers reported deductible business expenses on their Schedules C and Schedule F, later reaching an agreement with the IRS that the Schedule C expenses should have been reported on Schedule F.

Position of the IRS. The IRS disallowed the deductions, determining the wife did not conduct a trade or business activity for profit and because the business had not yet started during either 2012 or 2013.

Tax Court's Analysis. The Tax Court agreed with the IRS, concluding that the farming activities never moved beyond experimentation and investigation into an operating business. Although the Tax Court reasoned that some of the wife's farming activities could have constituted an active trade or business, costs were not segregated by activity. The Tax Court noted that income from the sale of eggs was an incidental receipt that was only realized after the wife had abandoned that venture. There was also no itemization of costs or basis in the cattle activity to allow for an estimation of any deductible loss.

HEMP AND MARIJUANA

IRC §280E limits income tax deductions for businesses that traffic in controlled substances to COGS as an adjustment to gross receipts.[251] Because hemp is no longer a Schedule I controlled substance, the §280E limitations do not apply. While hemp producers and resellers must follow the inventory costing methods of Treas. Reg. §1.471, they are not subject to the uniform capitalization rules if average gross receipts are $26 million or less (inflation-adjusted for years beginning after 2017) for the three preceding tax years and the business does not fall within the definition of a tax shelter. Likewise, if these tests are met, the business need not calculate an IRC §263A adjustment.

While hemp is not a Schedule I controlled substance, marijuana is (for purposes of federal law). In some states, marijuana is legal under state law for either medical or recreational purposes. Presently, 36 states authorize medicinal marijuana and 18 of those states also allow recreational use. In the other states, marijuana remains illegal at the state level. In those states where marijuana is a legal substance, the Tax Court has been presented with the issue of the application of §280E to such businesses. In those cases, the Tax Court determined that §280E bars a deduction for business-related expenses and that COGS must be adjusted to include indirect expenses in accordance with §263A.[252] This is the result, the Tax Court concluded, because the businesses were dealing in a controlled substance under federal law.

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250. *Costello v. Comm'r,* TC Memo 2021-9 (Jan. 25, 2021).

251. See also CCA 201504011 (Dec. 12, 2014).

252. See e.g., *Purple Heart Patient Center, Inc. v. Comm'r,* TC Memo 2021-38 (Mar. 29, 2021); *Alternative Health Care Advocates, et al. v. Comm'r,* 151 TC No. 225 (2018); *Loughman v. Comm'r,* TC Memo 2018-85 (Jun. 18, 2018).

Note. On June 28, 2021, Justice Thomas issued a statement respecting the Supreme Court's denial of certiorari (an order by which a higher court reviews a decision of a lower court) in *Standing Akimbo, LLC, et al. v. U.S.*[253] The case involved the issue of whether the plaintiff, a marijuana dispensary authorized under state law, had taken improper deductions for business expenses under §280E. Justice Thomas pointed out that the disjunction between federal and state law was problematic—that legality under state law and the absence of criminal enforcement do not ensure that a marijuana business will be treated like any other business that is legal under state law. He noted that the inability to deduct ordinary and necessary business expenses that "is still in the red after it pays its workers and keeps the lights on might nonetheless owe substantial federal income tax." He concluded his commentary by stating that, "A prohibition on intrastate use or cultivation of marijuana may no longer be necessary or proper to support the Federal Government's piecemeal approach."

While Justice Thomas' statement has no legal effect, it does send a message to the Congress concerning the current status of federal marijuana laws, including §280E and other applicable provisions.

253. *Standing Akimbo, LLC, et al. v. U.S.,* 955 F.3d 1146 (10th Cir. 2020), *cert. denied,* No. 20-645, 2021 U.S. LEXIS 3560 (U.S. Sup. Ct. Jun. 28, 2021).