2022 Workbook

Chapter 7: Agricultural Issues and Rural Investments

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Note. Corrections were made to this workbook through January of 2023. No subsequent modifications were made. For terms used in this chapter, see the **Acronyms and Abbreviations** section following the index.

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

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USDA'S EMERGENCY RELIEF PROGRAM UPDATE

The Extending Government Funding and Delivering Emergency Assistance Act[1] was signed into law on September 30, 2021. This legislation includes $10 billion for farmers impacted by weather disasters during calendar years 2020 and 2021. It directs $750 million to assist livestock producers for losses incurred due to drought or wildfires in calendar year 2021 through the Emergency Livestock Relief Program (ELRP). Through the Emergency Relief Program (ERP), the legislation also provides funding for noninsured crop losses incurred.

The United States Department of Agriculture (USDA) continues to release information about the ERP. Information released in August 2022 involved the question of whether income from the sale of farm equipment counted as farm income for purposes of the ERP. The USDA answered the question in a potentially adverse manner, as discussed later.

LIVESTOCK PROVISIONS[2]

To receive a phase one payment, a livestock producer must satisfy one of the following criteria during the calendar year 2021.[3]

- Suffered grazing losses in a county rated by the U.S. Drought Monitor as having a severe drought for eight consecutive weeks or at least an extreme drought, **and** have been approved for the 2021 Livestock Forage Disaster Program (LFP)
- Held permits that would have allowed their livestock to graze on federally managed lands had the permits not been later disallowed due to a wildfire

Various Farm Service Agency (FSA) forms must be submitted in lieu of an application.

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1. *Extending Government Funding and Delivering Emergency Assistance Act*, PL 117-43.
2. Ibid, §166.
3. *USDA to Provide Payments to Livestock Producers Impacted by Drought or Wildfire*. Mar. 31, 2022. USDA [www.usda.gov/media/press-releases/2022/03/31/usda-provide-payments-livestock-producers-impacted-drought-or] Accessed on Aug. 25, 2022.

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Computation of Payments and Limits for ELRP — Phase One[4]

ELRP payments are based on livestock inventories and drought-affected forage acreage or restricted animal units and grazing days due to wildfire reported by the producer on 2021 Form CCC-853, *Livestock Forage Disaster Program Application*. In general, payments equal the producer's gross 2021 LFP payment multiplied by 75%, although a higher percentage is available to historically underserved producers.[5] These payments are subject to a $125,000 payment limitation.

CROP PROVISIONS[6]

In late 2021, the USDA provided guidance to producers impacted by weather-related events. The former Wildfire and Hurricane Indemnity Program was retooled and renamed the ERP. The ERP authorizes two payments in two phases.

ERP phase one is presently underway, and ERP phase two may not happen until 2023. ERP payments may **only** be made to a producer with a crop eligible for federal crop insurance or the noninsurance crop disaster assistance program (NAP). The crop for which the recovery is sought must have been subject to a qualifying disaster, which is defined broadly. As a type of qualifying disaster, droughts are rated in accordance with the U.S. Drought Monitor, which publishes a list of qualifying counties.

An ERP payment is not made to any producer that did not receive a crop insurance or NAP payment in 2020 or 2021. Because of this requirement, crop insurance premiums that an ERP recipient has paid are reimbursed by recalculating the ERP payment based on the ERP payment rate of 85% and then backing out the crop insurance payment based on coverage level.

In addition, the ERP requires that the producer receiving a payment obtain either NAP or crop insurance for the next crop years. Also, a producer that received prevented planting payments can qualify for ERP phase one payments based on elected coverage.

Note. ERP payments are for damages occurring in 2020 and 2021, so they are not deferrable.

Computation of Payment and Limits for ERP and NAP

Once a producer submits their data to the FSA, an ERP application is sent for the producer to verify their application's accurancy. Applications started going out to producers in late May. An ERP payment replaces the producer's elected crop insurance coverage. It is based on a percentage with the total indemnity paid using the recalculated ERP percentage from which any crop insurance or NAP payment is subtracted.

Payment Limit.[7] The ERP payment limit is $125,000 for specialty crops. For all other crops, ERP imposes a limit of $125,000 combined for ERP phases one and two. However, for an applicant with "average adjusted gross farm income" (average adjusted gross income (AGI)) based on the immediate three prior years but skipping the first year back (e.g., in 2022, tax years 2018, 2019, and 2020 are used to compute the percentage) that is comprised of more than 75% from farming activities (the "75% test"), the normally applicable $900,000 AGI limit is dropped.[8] Thus, the payment limit goes to $900,000 for specialty crops and $250,000 for all other crops. There are separate payment limits for 2020 and 2021.

Note. ERP payments for **historically underserved producers** can be enhanced by an extra 15%. Such producers include beginning farmers, veterans, and socially disadvantaged producers.

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4. Ibid.
5. 87 Fed. Reg. 30165 (May 18, 2022).
6. *Extending Government Funding and Delivering Emergency Assistance Act*, PL 117-43, §166.
7. *Emergency Relief Program (ERP — Disaster Recovery Assistance for Commodity and Specialty Crop Producers*, p. 3. Aug. 2022. FSA. [www.fsa.usda.gov/Assets/USDA-FSA-Public/usdafiles/FactSheets/2022/fsa_erp_factsheet_2022_051222_final_v2.pdf] Accessed on Aug. 25, 2022.
8. 87 Fed. Reg. 30170 (May 18, 2022).

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Definition of Farm Income.[9] Farm income for ERP purposes includes the following.

- Net income from Schedule F, *Profit or Loss From Farming*
- Pass-through income from farming activities
- Wages from a farming entity
- Interest charge domestic international sales corporation (IC-DISC) income from an entity that materially participates in farming (has a majority of gross receipts from farming)
- Income from packing, storing, processing, transporting, and shedding of farm products
- Gains from the sale of farm equipment, but only if farm income is at least two-thirds of overall AGI (excluding gains from equipment sales and the sale of farm inputs).

> **Observation.** Under the Tax Cuts and Jobs Act (TCJA), for tax years after 2017, a trade-in of farm equipment is treated as a sale that is reported on Form 4797, *Sales of Business Property*. As a result, many farmers may have little income reported on Schedule F for a tax year in which they incurred a large gain from trading in farm equipment reported as having been sold on Form 4797. Thus, sale of farm equipment could cause such a farmer not to receive an additional ERP payment.

The two-thirds rule likely applies to income from custom farming or harvesting services and the income derived from providing seed to farmers (offset by allocated expenses).

Average AGI is "comparable to the net income from farming and related operations" and is distinct from farm AGI for federal tax purposes.[10] Calculating this amount requires determining what qualifies as gross farm income; from this number, net income from farming operations, or average AGI, can be derived.

> **Note.** Loss years can be used in the AGI calculation. If negative farm AGI is greater than total negative AGI by at least 75%, the farmer qualifies. In addition, the 3-year computation is simply the applicant's net income from farming compared with all of the applicant's other sources of income as reported on the tax return.

If an enhanced payment limit is sought on behalf of an entity,

> *...all members of that entity must also complete Form FSA-510 [Request for an Exception to the $125,000 Payment Limitation for Certain Programs] and provide the required certification according to the direct attribution provisions in 7 CFR 1400.105, "Attribution of Payments."*[11]

Form FSA-510 requires each entity owner, tracked through four levels of ownership, also satisfy the more than 75% test.[12] For this purpose, wages the entity pays count as farm income. If one or more owners fail to satisfy the test, the extra payment limit is reduced by the disqualified owner(s) share(s), but there is no reduction to the original payment limit. Wages and dividends paid by a materially participating farm corporation qualify as farm income. For this purpose, a materially participating farm corporation is one with more than 50% of gross receipts from farming. If an entity has not been in existence for the three years for which average AGI is computed, AGI from preceding entities can be used.[13]

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9. 87 Fed. Reg. 50829 (Aug. 18, 2022).

10. *FSA Handbook: Payment Limitation, Payment Eligibility, and Average Adjusted Gross Income — 6-PL*, p. 8-71. Apr. 29, 2022. FSA. [www.fsa.usda.gov/Internet/FSA_File/6-pl_r00_a03.pdf] Accessed on Aug. 25, 2022.

11. 87 Fed. Reg. 30169 (May 18, 2022).

12. *FSA Handbook: Payment Limitation, Payment Eligibility, and Average Adjusted Gross Income — 6-PL*, p. 3-2. Sep. 20, 2020. FSA. [www.fsa.usda.gov/Internet/FSA_File/6-pl_r00_a03.pdf] Accessed on Aug. 25, 2022.

13. Ibid, p. 8-24.

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Example 1. Able Farm Co. (not a general partnership) is eligible for $300,000 of ERP related to crop insurance proceeds on account of drought damage to the farm's 2021 wheat crop. All of Able Farm Co.'s income is derived from farming. Able Farm Co. is eligible for an original payment limit of $125,000 of ERP payments and could receive the additional $125,000 payment limit depending on the facts.

Able Farm Co. has four shareholders. Two shareholders who own 50% of Able Farm Co. actively farm and receive wages and dividends from the company. They also rent land to the corporation. Assume that their farm income meets the 75% test. Conversely, the other two shareholders who own the other 50% of Able Farm Co. are **not** involved in its farming operations, have off-farm wages, and do not satisfy the 75% test. Their failure to meet the 75% test individually means that the additional $125,000 payment is reduced by 50%. Thus, Able Farm Co. is eligible to receive $187,500 of ERP payments ($125,000 + $62,500).

Example 2. SunGro Cherry Farm qualifies for $950,000 of ERP because of weather damage to its cherry crop. SunGro is owned equally by four owners, two of which meet the 75% test. SunGro is eligible for the original payment limit of $125,000 and an additional payment limit of $775,000 ($900,000 – $125,000). But the additional payment limit must be reduced by the 50% ownership of the shareholders who do not meet the 75% test. Thus, the total ERP payment that SunGro Cherry Farm receives is $512,500 ($125,000 original payment limit + $387,500 (0.5 × $775,000 additional payment limit)).

Certification.[14] To get the enhanced payment limit, a CPA or attorney must prepare a letter to be submitted with Form FSA-510 certifying that the applicant's AGI is over the 75% threshold, thereby satisfying the 75% test. The FSA provides a form letter that can be used for this certification.[15] The certification may allow married farmers to eliminate the off-farm income of a spouse and make it possible to meet the 75% test if it otherwise would not be met.

Note. An attorney may sign Form FSA-510, but a CPA should write the letter.[16]

UPDATE ON FARM NOLs

TCJA made changes to the net operating loss (NOL) rules, including farm NOLs. Further amendments were made legislatively and by IRS guidance in 2020 and 2021.[17] However, the multiple changes have created confusion for taxpayers and tax preparers.

An NOL generally is the amount by which a taxpayer's business deductions exceed its business income.[18] For years beginning before 2018, an NOL was carried back two years (five years for farming losses) and carried forward 20 years to offset taxable income.[19] Taxpayers could elect to forgo the carryback period.[20] A separate election was available to farmers to forgo the 5-year carryback, allowing a 2-year carryback.[21]

Note. NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.[22]

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14. Ibid, pp. 8-64 – 8-74.
15. Ibid, pp. 8-73 – 8-74.
16. Ibid.
17. *Covid-Related Tax Relief Act of 2020.* PL 116-260, §281(a), adding *CARES Act.* PL 116-136, §2303(e); IRS Pub. 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts;* Rev. Proc. 2021-14, 2021-30 IRB 158.
18. IRC §172(c).
19. Pre-TCJA §172(b)(1)(A).
20. IRC §172(b)(1).
21. Pre-TCJA §172(b)(1)(B)(iv).
22. IRC §172(b)(2).

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TIMING FOR NOL DEDUCTION CHANGED BY TCJA

The deduction for an NOL may not exceed 80% of taxable income for NOLs generated for taxable years **beginning** after December 31, 2017.[23] NOLs for years beginning before January 1, 2018, are not restricted to 80% of taxable income.[24]

> **Note.** Although prior law contained provisions limiting the amount of alternative minimum tax NOL to no more than 90% of alternative minimum taxable income, regular NOLs were not restricted.

FARM NOLs

Except for NOLs attributable to a farming activity, NOLs generated for taxable years ending after December 31, 2017, may not be carried back.[25] The effective date of the TCJA provision for farm NOLs was changed to years beginning after December 31, 2017.[26] NOLs attributable to farming activities (farming NOLs) must be carried back two years unless the taxpayer irrevocably elects to forgo the carryback period.[27]

> **Note.** The excess business loss (EBL) rule of IRC §461(l) allows the offset of farm (or other business) losses against $250,000 of other income ($500,000 for married filing jointly), as adjusted for inflation. Thus, the largest NOL that a farmer can carry back two years is limited to these amounts. The EBL limitation was originally in place through 2025 but was extended in 2021 through 2026. The Inflation Reduction Act extends the EBL limitation through 2028.[28]

A farming NOL is the lesser of the amount of the NOL computed from income and deductions from a farming business, or the amount of the NOL for the year.[29] A farming business is defined as a trade or business that must involve the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity.[30]

A farming NOL is treated as a separate NOL to be considered after the remaining portion of the NOL for the year.[31] However, an NOL can offset other sources of income.

> **Note.** Separate tracking for farming NOLs is required to determine the order in which they may be absorbed.

NOLs that are carried forward to successive years are subject to certain modifications and adjustments attributable to the intervening years before they can be used to offset taxable income.[32] NOLs for years beginning after 2017 are not subject to the 20-year carryover limitation.[33] NOLs from years ending before January 1, 2018, continue to be subject to the 20-year carryforward rules. Records must be maintained to track the NOL carryforwards from both pre-effective-date years and post-effective-date years.

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23. IRC §172(a)(2), as amended by *Tax Cuts and Jobs Act,* PL 115-97, §13302(a)(1).
24. *Tax Cuts and Jobs Act,* PL 115-97, §13302(e)(1).
25. *Tax Cuts and Jobs Act,* PL 115-97, §13302(e)(2). The provision also applies to property and casualty insurance companies.
26. *CARES Act,* PL 116-136, § 2303(c)(1).
27. IRC §172(b)(1)(B).
28. *Inflation Reduction Act,* PL 117-69, §13903.
29. IRC §172(b)(1)(B)(ii).
30. Treas. Reg. §1.263A-4(a)(4)(i).
31. IRC §172(b)(1)(B)(iii).
32. IRC §172(d).
33. IRC §172(a)(2)(B).

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Consolidated Appropriations Act of 2021 (CAA '21) Election

The CAA '21 modified the TCJA provisions for farmers. Under the CAA '21, taxpayers with farming NOLs for years that began in 2018, 2019, or 2020 can elect to waive the 5-year NOL carryback period (and instead utilize a 2-year carryback period).[34] The election must generally be made by the due date, including extensions, for filing the taxpayer's original return. For returns filed prior to the enactment of the COVID-Related Tax Relief Act of 2020 (CRTRA), however, the taxpayer is treated as making the election if it has not utilized the 5-year carryback.

Amended Return. A taxpayer can file an amended return by the due date, including extensions, for the first tax year ending after the enactment of the CRTRA (i.e., the due date for the calendar 2020 income tax return) to revoke the election to not utilize the carryback period.

> **Note.** The revocation of a 2018 or 2019 election to forgo the 2-year carryback and the election to forgo the 5-year carryback for the 2018, 2019, and 2020 returns are to be made in a manner prescribed by the IRS.[35]

If the taxpayer waives the 5-year carryback, thus accepting the 2-year farm NOL carryback provision, the NOL for that year may offset up to 80% (rather than 100%) of the pre-NOL taxable income of the carryback or carryover year.[36]

Practitioner Planning Tip

Accepting the 80% limitation on reduction of pre-NOL taxable income may be beneficial. The limitation may leave taxable income to be taxed in the lowest tax brackets. Any tax liability might be offset by child credits, education credits, and other personal tax credits that, if not used, are wasted. For pre-2018 years, the personal exemption will not be wasted. The 80% limitation affects farm income averaging, however. Usually, it is beneficial to spread the NOL deduction over multiple years, having the effect of reducing higher-bracket income.

Taxpayers with a 2018 or 2019 farming loss can also revoke their previous election to waive the 2-year carryback period.[37]

Options. As a result of these changes, farmers may:

- Leave previous 2-year carrybacks of 2018 and 2019 NOLs in place,
- Amend the 2-year carrybacks to utilize the 5-year carryback provision of the TCJA, or
- Elect to forgo the carrybacks entirely.

> **Note.** Final decisions for 2018 and 2019 NOLs had to be made by the due date (including extensions) for the tax return for the first year ending after December 27, 2020.

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34. *COVID-Related Tax Relief Act of 2020*, PL 116-260, §281(a), adding *CARES Act,* PL 116-136, § 2303(e).
35. Rev. Proc. 2020-24, 2020-18 IRB 750.
36. *COVID-Related Tax Relief Act of 2020*, PL 116-260, §281(a).
37. Ibid.

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Affirmative Election. The IRS released guidance prescribing when and how to make an election regarding farm NOLs.[38] Taxpayers with a farm NOL may make an affirmative election to disregard the Coronavirus Aid, Relief, and Economic Security (CARES) Act amendments, allowing the farmer to carryback the 2018, 2019, and 2020 farm NOL two years rather than five years.

The taxpayer must attach a statement to that tax return with the following verbiage.

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 net operating loss 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 Revenue Procedure 2021-14, in [list each applicable taxable year beginning in 2018, 2019, or 2020].

Note. The election is all or nothing. The taxpayer must choose either the 2-year farm NOL carryback provision for all loss years within 2018 through 2020, or not.

Deemed Election. If the taxpayer with a farm NOL filed a federal income tax return before December 27, 2020, disregarding the CARES Act amendments to the NOL provision, the taxpayer is treated as having made a deemed election to utilize the 2-year carryback provision. The deemed election applies unless the taxpayer amends the tax return to reflect the CARES Act amendments by the revenue procedure due date (including extensions of time) for filing the taxpayer's federal income tax return for the first taxable year ending after December 27, 2020.[39] An amended return could change from the 2-year carryback originally filed to use a 5-year carryback period or the taxpayer could waive the carryback period entirely.

The taxpayer may revoke a previously irrevocable election to waive the 2-year carryback period for a federal tax return filed before December 27, 2020, applicable to a farm NOL for the years beginning in 2018 or 2019. The due date for revoking the waiver election is the date that is three years after the due date, including extensions of time, for filing the return for the taxable year the farm NOL was incurred. The revocation opportunity does not apply to the waiver of the 5-year NOL carryback opportunity. However, taxpayers appear to be allowed to make an affirmative election as described above, regardless of the waiver election.

The revocation statement must include the following verbiage.

Pursuant to section 4.01 of Rev. Proc. 2021-14 the taxpayer is revoking a prior §172(b)(1)(B)(iv) or § 172(b)(3) election not to have the two-year carryback period provided by § 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.

38. Rev. Proc. 2021-14, 2021-30 IRB 158.

39. Rev. Proc. 2021-14, 2021-30 IRB 158.

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JOINT TENANCY AND INCOME TAX BASIS AT DEATH

With the federal estate and gift tax applicable exclusion amount set at $12.06 million for decedent's dying in 2022 and gifts made in 2022,[40] a federal taxable estate at death is a concern for very few. What is much more important for most people, however, is income tax basis planning. Increased basis can produce smaller gains upon sales of property and higher annual deductions from depreciation. Many farm and ranch operations have significant deferred income tax liabilities that can only be resolved by higher tax basis upon death. That is because property that is included in a decedent's estate at death receives an income tax basis equal to the property's fair market value (FMV) as of the date of death.[41] As a result of this rule, much of current estate planning involves techniques to cause inclusion of property in a decedent's estate at death. Even though the property will be subjected to federal estate tax, the value will be excluded from tax by virtue of the unified credit that can offset up to $12.06 million of taxable estate.

Note. For more information on the unified credit, see the 2022 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Tax Considerations in the Distribution of Estate Assets.

Farm taxpayers have an especially keen interest in and benefit from this increase in basis, often called **stepped-up basis.** Heirs of farm property can obtain additional depreciation deductions from this computation.

Example 3. John, an active farm operator who reports cash basis income on Schedule F, dies on August 4 with the assets shown in the following table included in his estate. John's tax basis and the FMV of the assets are also shown. John's heirs receive an increase in basis (stepped-up basis) under IRC §1014 to the FMV of the assets.

Asset	Basis	FMV	Tax Benefit to Heirs
Land	$100,000	$1,000,000	Less gain if land is sold
Grain inventory	0	150,000	Less gain when grain is sold
Growing crops	0	400,000	Less gain when grain is sold
Prepaid expenses	0	75,000	Increased deductions
Machinery	0	800,000	Depreciation over 5 or 7 years
Machine shed	0	100,000	Depreciation over 20 years
Grain bins	0	200,000	Depreciation over 7 years

Even though John's tax basis was only $100,000, his heirs have significant tax benefits from reduced gains upon sale or additional deductions over the next several years.

JOINT TENANCY BASICS

Joint forms of property holding between spouses have been widely used among farm families because of certain supposed advantages, one of which is the simplicity of transferring property upon death. A distinguishing characteristic of joint tenancy is the right of survivorship. That means that the surviving joint tenant(s) become the full owner(s) of the jointly held property upon the death of the other joint tenant regardless of the terms of the deceased joint tenant's will.

Upon a conveyance of real property to two or more persons, a tenancy in common is generally created unless it is clear in the deed or other conveyancing document that a joint tenancy is intended. In other words, the legal presumption is against joint tenancy.

40. Rev. Proc. 2021-45, 2021-48 IRB 764.

41. IRC §1014.

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Example 4. Alec Trician conveys Blackacre to "Michael and Kelsey, husband and wife." This results in Michael and Kelsey owning Blackacre as tenants-in-common. To own Blackacre as joint tenants, Blackacre needed to be conveyed to them as required by state law. The typical language for creating a joint tenancy is to "Michael and Kelsey, husband and wife, as joint tenants with right of survivorship and not as tenants in common."

ESTATE TAX TREATMENT OF JOINT TENANCY PROPERTY

Nonspousal Rule

For joint tenancies involving persons other than husbands and wives, property is taxed in the estate of the first to die except to the extent the surviving owner(s) prove consideration for its acquisition.[42] This is the **consideration furnished rule.** As a result, property could be taxed fully at the death of the first joint tenant to die (if that person provided funds for acquisition) and again at the death of the survivor. Whatever portion is taxed in the estate of the first to die also receives a new income tax basis based on the FMV of that portion at the date of death.[43]

Example 5. Bob and Bessie Black, brother and sister, purchased a 1,000-acre Montana ranch in 1970 for $1 million. Bob provided $750,000 of the purchase price and Bessie provided the remaining $250,000. At all times since 1970, they have owned the ranch in joint tenancy with right of survivorship. Bob died in 2022 when the ranch had a FMV of $2.5 million. Bob's estate includes 75% of the date of death value or $1.875 million.

Bessie, as the surviving joint tenant, now owns the entire ranch. Her income tax basis in the ranch upon Bob's death is computed as follows.

Value included in Bob's estate	$1,875,000
Bessie's contribution toward purchase price	250,000
Bessie's income tax basis in ranch	$2,125,000

If Bessie were to sell the ranch soon after Bob's death for $2.5 million, she would incur a maximum federal capital gain tax of $75,000, computed as follows.

Sale price	$2,500,000
Bessie's income tax basis	(2,125,000)
Taxable gain	$ 375,000
Maximum capital gain tax rate	× 20%
Maximum tax liability	$ 75,000

Note. While property held in joint tenancy is not included in the probate estate for probate purposes, the value of the decedent's interest in jointly held property is potentially subjected to federal estate tax and state inheritance or state estate tax to the extent the decedent provided the consideration for its acquisition.

Observation. If an estate representative cannot show that the surviving tenant(s) provided consideration for the acquisition of the property, the value of all the jointly held property will be included in the gross estate of the decedent. Accurate recordkeeping is a must.

42. IRC §2040(a).

43. Treas. Reg. §20.2040-1(c). See also *Estate of Fratini v. Comm'r*, TC Memo. 1998-308 (if part of the consideration for property held in a nonspousal joint tenancy was contributed by the surviving joint tenant, the part of the value of the property proportionate to that consideration is excluded from the decedent tenant's estate under Treas. Reg. §20.2040-1(a)(2)).

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Contribution of Consideration

Because the basis issue is tied to contribution of consideration, it is important to examine the various ways in which that contribution to a joint tenancy might be made. IRC §2040 includes all forms of titled property containing a survivorship feature, including tenancy by the entireties real estate titles, deposits of money, or purchases of bonds payable to the survivor. Inherited or gifted joint property is taxed to the decedent in accordance with the decedent's fractional share.[44] In all other cases, the entire value of the property is taxed, except such amount as the survivor can prove was the result of a contribution "in money or money's worth, furnished by the survivor." However, money or other property given by the decedent to the surviving joint owner and thereafter contributed to the purchase price of the joint property is not recognized as a contribution by the donee.[45] The same is true for appreciation in the value of property given to the survivor by the decedent which is then placed in joint tenancy or contributed to the acquisition of joint tenancy.

Example 6. Morey Bund bought a piece of land in Sue Flay's name for $100,000. The land appreciated in value to $200,000 and was then deeded by Sue in joint tenancy between Morey and her. The amount of the contributions by Sue in money or money's worth would be zero.

Note. The term **tenancy by the entirety** means joint ownership of title by husband and wife, in which both enjoy the right to the entire property, provided they were legally married when they jointly received the title.[46] When one spouse dies, their interest in the property transfers immediately to their surviving partner.

MARITAL JOINT TENANCIES

For joint tenancies involving only a husband and wife, the property is treated at the first spouse's death as belonging 50% to each spouse for federal estate tax purposes.[47] This is known as the **fractional share rule.** Thus, only half of the value is taxed at the death of the first spouse. Although no federal estate tax is incurred on the property passing to the surviving spouse, only half of the property receives a new income tax basis equal to FMV at the time of death. It does not matter which spouse provided the consideration for the spousal joint property.[48]

Observation. An estate planner should carefully analyze the effect of joint property ownership on basis adjustment at the death of one of the joint owners. Generally, only a one-half interest in qualified joint interests will receive a step-up in basis. However, if the first spouse to die had owned all the property, a full step-up would have been obtained.

If inception of the tenancy involved a gift by the decedent to the surviving spouse, the survivor's basis in the property will equal the original transferred basis. As a result, the sale of the property by the surviving spouse could result in a capital gain.

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44. Treas. Reg. §20.2040-1(a).

45. Treas. Reg. §20.2040-1(c)(4).

46. *Tenancy by the Entirety.* edition 2. Hill, Gerald and Hill, Kathleen. 1981-2005. *West's Encyclopedia of American Law.* [legal-dictionary.thefreedictionary.com/Tenancy+by+the+Entirety] Accessed on August 24, 2022.

47. IRC §2040(b).

48. IRC §1014.

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Special Rule

In 1992, the Sixth Circuit Court of Appeals applied the consideration furnished rule to a husband-wife joint tenancy in farmland with the result that the entire value of the jointly held property was included in the gross estate of the husband, the first spouse to die.[49] The full value was subject to federal estate tax but was covered by the 100% federal estate tax marital deduction, eliminating federal estate tax. In addition, the entire property received a new income tax basis, which was the objective of the surviving spouse. The court reached this result because of statutory changes to the applicable Code sections that were made in the late 1970s. To take advantage of those changes, the court determined, it was critical that the jointly held property at issue was acquired before 1977.

Under the facts of the case, the farmland was purchased in 1955 for $38,500 exclusively with the husband's funds. The surviving wife sold the farmland in 1988 for $3,663,650 after her husband's death in late 1987. Under the pre-Tax Reform Act of 1976 rules on joint tenancy contribution, a decedent's gross estate included the entire value of property held in joint tenancy with another person except the portion of that value contributed by the other person (instead of arbitrarily including half of the value of the joint tenancy property). The surviving wife argued that there was nothing in any legislation that applied the 50% inclusion rule to pre-1977 joint interests, but that such interests were still subject to the full marital deduction under the 1981 Act.

The *Gallenstein* court reasoned that the 1976 Act applied only to joint interests created after December 31, 1976, and that the 1981 amendments which resulted in the one-half taxability expressly applied to decedents dying after December 31, 1981. The 1981 amendments did not repeal the January 1, 1977, effective date of the 1976 amendments, which did not apply to joint interests created before 1977. Because the surviving spouse as a joint tenant had made no contribution to the property, she was entitled to a full step-up in basis. The result was that the entire gain on sale was eliminated because of the full basis step-up.

In 1996 and 1997, the federal district court for Maryland reached a similar conclusion.[50] In 1997, the Fourth Circuit Court of Appeals followed *Gallenstein* as did a federal district court in Florida.[51]

In 1998, the Tax Court agreed with the prior federal court opinions.[52] Under the Tax Court's reasoning, the fractional share rule cannot be applied to joint interests created before 1977. This is a key point. If the jointly held assets had declined in value, such that death of the first spouse would result in a lower basis, the fractional share rule would result in a more advantageous result for the survivor in the event of sale if the survivor could not prove contribution at the death of the first to die. In late 2001, the IRS acquiesced in the Tax Court's opinion.[53]

TRANSFERS TO LIVING TRUSTS

While a transfer of property to a revocable living trust ordinarily does not trigger a taxable gift, transfer of joint tenancy property to such a trust has unpredictable gift and estate tax consequences, depending on the language of the trust document. For example, in *Estate of Hornor v. Comm'r,*[54] jointly held property was transferred to a trust that was revocable only with the consent of both joint tenants. The trust was to continue for their joint lives and to become irrevocable upon the death of the first to die. The husband died first and the issue in his estate was whether §2040 should apply to require proof of contributions by the surviving wife to exclude property from taxation in the husband's estate. The husband was found to have provided all the consideration. Upon the wife's later death, half of the trust value was taxed to her estate as a transfer with a retained life estate under §2036. The court concluded that the wife had an interest in the jointly held property when it initially transferred to the trust.

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49. *Gallenstein v. U.S.,* 975 F.2d 286 (6th Cir. 1992).

50. *Anderson v. U.S.,* 96-2 U.S. Tax Cas. (CCH) ¶60,235 (D. Md. 1996); *Wilburn v. U.S.,* 97-2 U.S. Tax Cas. (CCH) ¶50,881 (D. Md. 1997).

51. *Patten v. U.S.,* 116 F.3d 1029 (4th Cir. 1997), *aff'g* 96-1 U.S. Tax Cas. (CCH) ¶ 60,231 (W.D. Va. 1996); *Baszto v. U.S.,* 98-1 U.S.Tax Cas. (CCH) ¶60,305 (M.D. Fla. 1997).

52. *Hahn v. Comm'r,* 110 TC 140 (1998).

53. *Hahn v. Comm'r,* 110 TC 140 (1998), *acq.,* 2001-42 IRB 319.

54. *Estate of Hornor v. Comm'r,* 130 F.2 649 (3d Cir. 1942).

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CONCLUSION

There are estate planning drawbacks for owning property in joint tenancy at death, particularly in estates with values greater than the unified credit exemption equivalent. It also presents challenges when qualification for certain post-mortem estate planning techniques is critical, and because of its inflexible ownership structure. However, as the unified credit exemption equivalent has increased dramatically since 2017, joint tenancy has gained popularity. Also, for pre-1977 marital joint tenancies where one spouse provided all the funds to acquire the property and that spouse dies, the full value of the property will be included in the decedent's gross estate. But, in many of these estates, the full value will be excluded from federal estate tax. More importantly, the surviving spouse will receive an income tax basis equal to the value of the property at the time of the first spouse's death. In agriculture, many pre-1977 marital joint tenancies involving farmland still exist.

> **Caution**. In addition to federal estate tax implications, state tax laws may cause a further analysis of property ownership.

ESTATE TAX EXEMPTION (CLAWBACK)

The Treasury has proposed regulations[55] that would prevent certain decedents' estates from being subject to federal estate tax if the federal estate and gift tax applicable exclusion amount drops to $5 million (adjusted for inflation) for deaths after 2025 as it is set to do under current law. The TCJA set the applicable exclusion amount at $10 million (adjusted for inflation) for deaths occurring and taxable gifts made after 2017.[56] The amount, for 2022, is $12.06 million per person/estate.[57]

BACKGROUND

Historical

Estate and gift taxes were unified into a single system in 1976 and remained unified through 2003. The systems are re-unified for transfers occurring after 2010. Under this unified system, gift taxes are calculated based on accumulated taxable gifts made by an individual during life.[58] Estate taxes are calculated on the decedent's taxable estate at death, reduced by gift taxes paid on post-1976 taxable gifts (except for gift taxes paid within three years of death).[59] A unified estate and gift tax credit is available to offset estate tax liability and is a function of the amount of applicable exclusion available at death.[60] In other words, the credit will be an amount that offsets the tax liability to the extent of the applicable exclusion available to the decedent's estate at death.

Computation of Federal Estate Tax[61]

A decedent's taxable estate is determined by subtracting from the decedent's gross estate (adjusted for gifts and gift tax within three years of death except for amounts covered by the federal gift tax annual exclusion), costs of estate administration, allowable losses, the marital deduction, and charitable deduction. Taxable gifts after 1976 (those not covered by the federal gift tax annual exclusion, marital deduction, or charitable deduction) are included in the taxable estate for purposes of determining the amount of prior use of the unified credit and the point to begin figuring federal estate tax on the graduated tax schedule.

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55. NPRM Reg-118913021 (Apr. 26, 2022); 87 Fed. Reg. 24918 (Apr. 27, 2022).
56. IRC §2010(c)(3).
57. Rev. Proc. 2021-45, 2021-48 IRB 764.
58. IRC §2001.
59. Ibid.
60. See IRC §§2505 and 2010 for unified gift and unified estate tax rules.
61. Ibid; Instructions for Form 706.

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Potential Problem

Based on this manner of calculating a decedent's taxable estate, a question arises if the applicable exclusion amount that applies at the time of a decedent's death is different from the amount that applied with respect to any post-1976 taxable gifts made by the decedent during life. For example, assume a donor made a large taxable gift in 2020 that was completely offset by the unified credit. If the donor died in 2026 (under current law) when the applicable exclusion amount is lower, would those prior gifts now be deemed to be taxable gifts that are pulled back into the estate for estate tax purposes? In other words, would those prior taxable gifts be "clawed back" and treated as includable in the decedent's estate under IRC §2001(b)?

2019 Final Regulations[62]

In 2019, final regulations were issued specifying that gifts made when the applicable exclusion exceeded the amount of the exclusion at death would **not** be pulled back into the estate at death. The regulations addressed the situation of persons who make lifetime gifts after 2017 and before 2026. A donor's estate is not to be taxed on completed gifts that were not subject to gift tax when made because a higher applicable exclusion amount applies at the time of death. In other words, if a person makes a $12.06 million gift in 2022 (the full exclusion amount) and dies after 2025, the applicable exclusion amount will be $12.06 million rather than $5 million (adjusted for inflation from 2011 to the year of death).

> **Note.** The final regulations specify that the portion of the unified credit allowed in computing estate tax that is attributable to the applicable exclusion amount is the sum of the amounts attributable to the exclusion amount that is allowed as a credit when computing the gift tax payable on gifts the decedent made during life.

If a person makes lifetime gifts that are less than the full applicable exclusion amount for the year of the gift, but the gifted amount exceeds the exclusion amount for the year of death, there is no clawback. Instead, the exclusion for computing estate tax at death will be the amount of the exclusion for the year of death. For example, if an individual makes a $5 million gift in 2022 (when the applicable exclusion amount for estate and gift tax purposes is $12.06 million) and dies after 2025 when, under current law, the exemption will be $5 million (adjusted for inflation from 2011), the individual's estate tax liability will get the benefit of the exclusion as of the date of the gift. In the example, that would be $12.06 million and a taxable gift amount of the difference between the exclusion at the time of the gift, and the exclusion as of date of death will not be pulled back into the estate for estate tax purposes. Thus, the clawback is avoided.

> **Note.** Under current law, the applicable exclusion amount is a "use it or lose it" concept. It benefits a person who lives beyond 2025 to the extent gifts made after 2017 and before 2026 exceed the applicable exclusion amount at the time of death.

The final regulations also retain the rule allowing the surviving spouse to "port" any unused amount of the applicable exclusion at the first spouse's death (known as the deceased spouse unused exclusion (DSUE) amount) to be added to the surviving spouse's exclusion amount. The applicable exclusion amount for the first spouse to die will increase the exclusion available to the surviving spouse.

Example 7. Kay dies in 2022 with no assets when the applicable exclusion amount is $12.06 million. Her widower, Dave, elects portability. If Dave dies after 2025, his applicable exclusion will be the exclusion amount for the year of death (assume $5 million plus an inflation adjustment) plus the $12.06 million DSUE from Kay's estate. If Dave makes any taxable gifts, any DSUE is deemed to be applied to those gifts before his exclusion amount is applied. If Dave dies after 2025, the DSUE applied to his taxable gifts is not reduced. The total amount of applicable credit that was used in computing Dave's gift tax based on the DSUE amount, plus the credit determined without clawback would be available for reducing estate tax in Dave's estate.

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[62] 84 Fed. Reg. 64995 (Nov. 26, 2019) creating Treas. Reg. §20.2010-1(c).

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The 2019 regulations, however, did not address how to treat incomplete gifts such as retained life estates or transfers subject to powers of appointment. These testamentary transfers are also included in the decedent's gross estate at death (as "includable gifts") and could be "clawed back" into the estate at death if the applicable exclusion amount were lower at that time then it was at the time of the transfer.

In the preamble to the 2019 regulations, the IRS anticipated certain potential abuses of the regulations. For example, for certain types of lifetime transfers that are included in a decedent's estate, if the transfer was made when the applicable exclusion amount is high (such as now), but the decedent dies at a time when the exclusion is lower, the 2019 regulation could produce a bonus. This is because when calculating the estate tax on these types of transfers, the gift is excluded from adjusted taxable gifts on line 4 of Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return.* The IRS did not address this potential abuse in the 2019 regulations and reserved the matter for further consideration and additional regulations after notice and comment.

> **Note.** The 2019 regulations also did not address whether the post-2025 reduction in the applicable exclusion amount will impact allocations of the generation-skipping exemptions made during 2018–2025.

PROPOSED REGULATIONS[63]

The proposed regulations remove these "includable gifts" from the estate tax computation. Specifically, the proposed regulations would remove from being clawed back into the decedent's estate, the value of the following.

1. Gifts subject to a retained life estate or subject to other powers or interests[64]
2. Gifts made by an enforceable promise to the extent unsatisfied at death
3. Transfers of certain applicable retained interests in corporations, partnerships, or trusts[65]
4. Transfers that would have been included in (1)-(3) above but for the transfer, relinquishment, or elimination of an interest, power, or property within 18 months of the decedent's death by the decedent alone or in conjunction with any other person, or by any other person[66]

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These transfers are removed from the possibility of clawback to the extent the taxable amount is 5% or less of the total amount of the transfer (as of the date of the transfer).

Example 8. Alex made a completed gift of a promissory note in the amount of $9 million.[67] At the time of the gift, the basic exclusion amount was $11.4 million. Alex never married and did not make any other gifts during her life. The note remained unpaid as of the date of Alex's death and as such, was an enforceable promise unsatisfied at death. Thus, Alex's basis exclusion remains at $6.8 million.

The assets that are to be used to satisfy the note are part of Alex's gross estate, with the result that the note is treated as includable in her gross estate for purposes of §2001(b) and is not included in her adjusted taxable gifts. Because the note is treated as includable in the gross estate and does not qualify for the 5% de minimis rule, the exception to the special rule found in Prop. Treas. Reg. §20.2010-1(c) applies to the gift of the note. **The credit to be applied to compute Alex's estate tax is based on the $6.8 million basic exclusion amount as of Alex's date of death,** subject to the limitation of §2010(d). The result would be the same if Alex or a person empowered to act on her behalf had paid the note within the 18 months prior to her death.

> **Note.** The proposed regulations also include examples of gifts to a grantor-retained annuity trust and a grantor retained income trust.

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63. NPRM Reg-118913-21 (Apr. 26, 2022); 87 Fed. Reg. 24918 (Apr. 27, 2022).

64. See IRC §§2035-2038 and 2042.

65. IRC §§2701-2702.

66. Prop. Treas. Reg. §20.2010-1(c)(3).

67. Based on Prop. Treas. Reg. §20.2010-1(c)(3)(iii).

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Effective Date

The proposed regulations, once finalized, are applicable to estates of decedent's dying on or after April 27, 2022.

DSUE

The IRS issued Rev. Proc. 2022-32 effective July 8, 2022, which supersedes Rev. Proc. 2017-34. It provides guidance for estates to elect portability of the DSUE amount as much as five years after the decedent's date of death. [68]

Note. For more information on DSUE and portability elections, see the 2022 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Tax Considerations in the Distribution of Estate Assets.

LIVESTOCK CONFINEMENT BUILDINGS AND SELF-EMPLOYMENT TAX

In addition to income tax, a tax of 15.3% is imposed on self-employment (SE) income. If a farmer constructs a confinement building, places their own livestock in the building, provides all management and labor, and pays all expenses, the net profit from the activity will be subject to SE tax. But what if the livestock production activity conducted in the confinement building is done under a contract with a third party? This section provides an analysis of whether the farmer's net income from the activity will be subject to SE tax.

BACKGROUND

SE income is defined as net earnings from self-employment activities. **Net earnings from self-employment** is defined as gross income derived by an individual from a trade or business that the individual conducts.[69] In general, income derived from real estate rents (and personal property leased with real estate) is **not** subject to SE tax unless the arrangement involves an agreement between a landowner or tenant and another party providing for the production of an agricultural commodity and the landowner or tenant materially participates.[70] For rental situations not involving the production of agricultural commodities where the taxpayer materially participates, rental income is subject to SE tax if the operation constitutes a trade or business "carried on by such individual."[71] Similarly, an individual rendering services is subject to SE tax if the activity rises to the level of a trade or business. In general, to be subject to SE tax, an activity must be engaged in on a substantial basis with continuity and regularity.

CONTRACT PRODUCTION

Whether SE tax applies to the net income derived from livestock production activities conducted in a farmer's confinement building pursuant to a contract with a third party depends on facts and circumstances.

The U.S. Tax Court provided guidance on the issue in 1995. In *Gill v. Comm'r,*[72] a corporation that produced, processed, and marketed chicken products bought breeder stock from primary breeders and placed them in farmer-owned buildings for 20 weeks. The placement of the chicks with individual farmers was done in accordance with production contracts. The petitioners (two different farmers) constructed broiler barns with the corporation's assistance in obtaining financing and established that the petitioners had the ability to maintain their facilities. Each contract was for 10 years, and the corporation paid the petitioners a fixed monthly amount tied to the space inside each building ($0.045 per month/per square foot) that was supplemented over time to reflect inflation. The petitioners were required to perform certain maintenance items, inspections, and general flock management responsibilities.

68. Rev. Proc. 2022-32, 2022-30 IRB 101.

69. IRC §1402.

70. IRC. §§1402(a)(1) and 1402(a)(1)(A).

71. See, e.g., *Rudman v. Comm'r,* 118 TC 354 (2002).

72. *Gill v. Comm'r,* TC Memo 1995-328 (Jul. 24, 1995).

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The petitioners did not report the income received under the contracts as subject to SE tax. They claimed that they did not materially participate in the production or the management of the production of the poultry in the barns that they leased to the corporation. As such, they claimed that the payments they received were excluded from the definition of "net earnings from self-employment" as "rents from real estate."

The Tax Court disagreed. The Tax Court noted that the apparent intent of the Congress was to exclude from SE tax only those payments for use of space and, by implication, such services as are required to maintain the space in condition for occupancy. Thus, when a taxpayer performs additional services of a substantial nature that compensation for the additional services can be said to constitute a material part of the payment made to the owner, the payment is income that is attributable to the performance of labor. It is not incidental to the realization of return from a passive investment, and the payment is included in the computation of the taxpayer's net SE earnings. Applying the analysis to the facts, the Tax Court determined that the petitioners (and their children) performed every task necessary to raise the flocks of birds that the corporation delivered. This constituted material participation subjecting the contract payments to SE tax. The payments were not excluded from net SE earnings as "real estate rents."[73]

PLANNING CONSIDERATIONS

Many agricultural production contracts like the ones at issue in *Gill* require the farmer/producer to perform substantial services in connection with the production of the livestock or poultry. Therein lies the problem. To avoid having the income subjected to SE tax, the farmer/building owner must not participate to a significant degree in the production activities or bear a substantial risk of loss.

One planning option to address the SE tax issue may be to split the contractual arrangement into two separate agreements. One agreement would be strictly for the rental of the building with Form 1099-MISC, *Miscellaneous Income,* issued for the rental income. Given the typically high capital costs for livestock confinement buildings, a return on capital shown as rent should not be unreasonable. A second agreement would be entered into providing for herd/flock management with the issuance of a separate Form 1099-NEC, *Nonemployee Compensation,* or a Form W-2, *Wage and Tax Statement*. These payments would be subject to SE tax or Federal Insurance Contributions Act (FICA) tax.

Significant Taxpayer Win

Another approach was established by the Tax Court in 2017. In *Martin v. Comm'r,*[74] the petitioners, a married couple, operated a farm in Texas. In late 1999, they built the first of eight poultry houses to raise broilers under a production contract with a large poultry integrator. The petitioners formed an S corporation in 2004 and set up oral employment agreements with the S corporation based on an appraisal for the farm which guided them as to the cost of their labor and management services. They also pegged their salaries at levels consistent with other growers. The wife provided bookkeeping services and the husband provided labor and management. In 2005, they assigned the balance of their contract to the S corporation. Thus, the corporation became the "grower" under the contract. In 2005, the petitioners entered into a lease agreement with the S corporation. Under the agreement, the petitioners rented their farm to the S corporation, under which the S corporation would pay rent of $1.3 million to the petitioners over a 5-year period. The court noted that the rent amount was consistent with other growers under contract with the integrator. The petitioners reported rental income of $259,000 and $271,000 for 2008 and 2009 respectively, and the IRS determined that the amounts were subject to SE tax because the petitioners were engaged in an "arrangement" that required their material participation in the production of agricultural commodities on their farm.

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73. See also *Schmidt v. Comm'r,* TC Memo 1997-41.

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

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The Tax Court determined that the "derived under an arrangement" language in IRC §1402(a)(1) meant that a nexus must be present between the rents the petitioners received and the arrangement that required their material participation. In other words, there must be a tie between the real property lease agreement and the employment agreement. The court noted the petitioners received rent payments that were consistent with the integrator's other growers for the use of similar premises. That fact was sufficient to establish that the rental agreement stood on its own as an appropriate measure of return on the petitioners' investment in their facilities. Similarly, the employment agreement was appropriately structured as a part of the petitioners' conduct of a legitimate business. Importantly, the Tax Court noted that the IRS failed to brief the nexus issue and simply relied on the Tax Court to broadly interpret "arrangement" to include all contracts related to the S corporation. Accordingly, the Tax Court held that the petitioners' rental income was not subject to SE tax. **This was a significant taxpayer win and identifies some key facts that should be in place to best distinguish income not being subject to SE tax.**

CONCLUSION

Aside from the "two-check" approach, leases should be drafted to carefully specify that the landlord is not providing any services or participating as part of the rental arrangement. Services and labor participation should remain solely within the domain of the employment agreement. In addition, leases where the landlord is also participating in the lessee entity must be tied to market value for comparable land leases.[75] If the rental amount is set too high, the IRS could argue that the lease is part of an arrangement that involves the landlord's services.[76] If the lessor does provide services, a separate employment agreement should put in writing the duties and compensation for those services.

Whether SE tax is incurred will likely be determined by the extent of involvement the owner retains regarding the confinement building. However, with the ability to claim substantial depreciation and large interest expense payments (associated with financing the confinement building), a loss could be created. Thus, classification of the arrangement as a rental activity with no SE tax may not be the best tax strategy. Instead, the preference might be to offset the loss against SE income. This last point raises a question of whether a taxpayer can "change horses" mid-stream when the confinement building is sufficiently paid for such that interest expense is lower and, also, depreciation deductions have dropped significantly. Whether the contract can be modified at that point so that SE tax is minimized requires a complete view of all aspects in order to obtain the desired taxpayer result.

75. See e.g., *Johnson v. Comm'r,* TC Memo 2004-56 (Mar. 9, 2004).

76. See, e.g., *Solvie v. Comm'r,* TC Memo 2004-55 (Mar. 9, 2004).

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TAX BENEFITS TO DEMOLISHING FARM BUILDINGS AND STRUCTURES

Inland hurricanes on August 10, 2020, and December 15, 2021, wreaked havoc on a great deal of agricultural assets in parts of Kansas, Nebraska, Iowa, Illinois, Indiana, and Minnesota. Many farm buildings and structures were damaged, and some were made irreparable and required demolition. That makes it important to determine the proper tax treatment of demolishing buildings and structures. Understanding the tax rules will also be of benefit in advising farm clients whether it is simply better to leave unused buildings and other improvements standing.

GENERAL RULES

Capitalize into Land Basis

IRC §280B provides that "in the case of the demolition of any structure…no deduction otherwise allowable under this chapter shall be allowed to the owner or lessee of such structure for any amount expended for such demolition, or any loss sustained on account of such demolition." Instead, such amounts "shall be treated as properly chargeable to capital account with respect to the land on which the demolished structure was located." Thus, the amounts must be capitalized and added to the income tax basis of the land on which the building or structure was located. Likewise, effective for tax years beginning after 1985, it is no longer possible to receive a tax deduction for the removal of trees, stumps, and brush and for other expenses associated with the clearing of land to make it suitable for use in farming.[77] Accordingly, the cost of removing trees and brush, capping wells, and grading the land to make it suitable for farming cannot be presently deducted. Instead, such costs are treated as development expenses (capital investment) that are added to the basis of the land and not deducted until the property is sold.

Use Before Demolishing

If a farm building or structure is used in the taxpayer's trade or business of farming before being demolished, depreciation can be claimed for the period of business use.[78] Upon demolition, the remaining undepreciated basis of the building or structure is added to the basis of the land along with the demolition costs. In situations where the taxpayer purchased the property with the intent of demolishing the buildings and/or structures after using them in their trade or business, the fact that the taxpayer ultimately intended to demolish the buildings is considered in making an apportionment of basis between the land and the buildings under Treas. Reg. §1.167(a)-5. In this situation, the amount allocated to the buildings/structures cannot exceed the present value of the right to receive rentals from the buildings/structures over the period of their intended use.

Abandonment

If the buildings and structures are simply abandoned, any remaining basis is treated as a disposition or a sale at a zero price. That means that the remaining income tax basis becomes an ordinary loss that is reported on Form 4797. If the abandoned buildings and structures are eventually demolished at least one year after the taxpayer ceased using them in the farm business, they have no remaining basis that could be recovered via depreciation and only the cost of demolition would be added to the land's basis.

Note. For more information on filing Form 4797, see the 2022 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Small Business Issues.

77. IRC §182, repealed by PL 99-514, §402(a), 100 Stat. 2221 (1986).

78. Treas. Reg. §1.165-3.

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DEMOLITION AFTER CASUALTY

As previously noted, the most recent inland hurricanes that pelted parts of Kansas, Nebraska, Iowa, Illinois, Indiana, and Minnesota with sustained winds near 100 miles-per-hour created significant damage to farm structures. When a casualty event such as this occurs, the normal capitalization rule of §280B does not apply when a structure damaged by the casualty is demolished. In Notice 90-21,[79] the IRS stated that the capitalization rule does not apply to "amounts expended for the demolition of a structure damaged or destroyed by casualty, and to any loss sustained on account of such demolition." Instead, the income tax basis of the structure is reduced by the deductible casualty loss before the "loss sustained on account of" the demolition is determined. That means for a farm building or structure destroyed in the recent inland hurricanes, for example, the income tax basis in the building or structure at the time of the casualty is deductible as a casualty loss but the cost of cleaning up the mess left behind is capitalized into the land's basis. In essence, the loss sustained before demolition is not treated as being sustained "on account of" the demolition with the result that the loss is not disallowed by §280B. It is an "abnormal" retirement caused by the "unexpected and extraordinary obsolescence of the building."[80]

Conversely, if a taxpayer incurs a loss to a building or structure and decides to withdraw a building or structure from use in the trade or business and then demolish it in a later year with no tax event occurring in the interim, the demolition costs are subject to the disallowance rule of §280B. In that situation, the taxpayer might be able to claim a casualty loss for the year in which the loss occurred (consistent with the casualty loss rules in place at the time), and if the structure is later demolished, the structure's basis must be reduced by the casualty loss that was allowed by IRC §165 before the nondeductible loss sustained on account of the demolition can be determined.[81]

TANGIBLE PROPERTY REGULATIONS

In late 2013, the IRS released final regulations providing rules regarding the treatment of materials and supplies and the capitalization of expenditures for acquiring, maintaining, or improving tangible property (the final repair regulations).[82] About a year later, the IRS issued final regulations on dispositions of tangible property, including rules for general asset accounts (GAA).[83] These regulations are generally effective for tax years beginning on or after January 1, 2014.

Under the regulations, a taxpayer generally must capitalize amounts paid to acquire, produce, or improve tangible property, but can expense items with a small dollar cost or short useful life. The regulations also provide a de minimis safe harbor that can be elected on a yearly basis to expense all items under a certain dollar cost. The repair regulations also contain specific rules for determining whether an expenditure qualifies as an improvement or a betterment (essentially following established caselaw) and provide a safe harbor for amounts paid for routine property maintenance. There is also an election that can be made to capitalize certain otherwise deductible expenses for tax purposes if they are capitalized for book purposes.

The repair/disposition regulations provide a potential opportunity for a taxpayer to continue depreciating a building/structure after demolition has occurred. Under the regulations, a taxpayer does not have to terminate a GAA upon the disposition of a building/structure. Thus, the taxpayer who has included buildings and structures in a GAA may choose whether to continue to depreciate them when they are disposed of (e.g., demolished) or capitalize the adjusted basis into the land under §280B.

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79. IRS Notice 90-21, 1990-1 CB 332.

80. See, e.g., *Gates v. U.S.,* 168 F.3d 478 (3d Cir. 19998), *aff'g* 81 AFTR 2d 98-1622 (M.D. Pa. 1998); *DeCou v. Comm'r,* 103 TC 80 (1994); FSA 200029054 (May 23, 2000); Treas. Reg. §1.167(a)-8(a).

81. IRS Notice 90-21, 1990-1 CB 332.

82. TD 9636, 2013-43 IRB 331.

83. TD 9689, 2014-36 IRB 456.

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The adjusted basis of any asset in a GAA that is disposed of is zero immediately before its disposition. The basis associated with such an asset remains in the GAA where it will continue to depreciate.[84] Consequently, the basis of a demolished building/structure where the cost of the demolition would be subject to capitalization under §280B is zero and the taxpayer can continue to depreciate the basis in the GAA. But, if only one demolished building/structure is in a GAA and the taxpayer elects to terminate the GAA, the adjusted basis of the building/structure would, in effect, be capitalized under §280B. Likewise, the strategy does not apply if the building or structure is acquired in the same year that it is demolished or if the taxpayer intended to demolish the building/structure at the time it was acquired.[85]

The opportunity to use the technique is further limited by a requirement that the taxpayer must have elected to include the building in a GAA in the year the taxpayer placed the building/structure in service and is in compliance with the GAA rules. The election must have been made on an original return.[86]

AGRICULTURE-RELATED NONDEPRECIABLE ITEMS

Over time, assets wear out or cease to be useful with their cost, in effect, being consumed during their period of usefulness in the agriculture business. In recognition of this cost, the tax law allows an annual deduction for depreciation. In some instances, the total allowable depreciation for the asset can be claimed entirely in the first year the taxpayer places the asset in service.

In general, depreciation is allowable on all tangible property with a limited useful life of more than one year that is used in the trade or business of farming or ranching or held for the production of income. Property that is depreciable includes machinery and equipment, buildings, patents, purchased livestock, and property held for rental. Property that is generally not depreciable includes inventories or stock in trade, a building used only as a residence, and an automobile used only for pleasure. Land is not depreciable because it does not have a determinable useful life.[87]

AGRICULTURAL-SPECIFIC ASSETS

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

Grazing Preferences

In general, grazing preferences are not depreciable or amortizable. In *Uecker v. Comm'r*,[88] the court held that grazing privileges had an indeterminant life because the taxpayers had preferential application and renewal privileges under state and federal law. They were not depreciable under IRC §178 because of the taxpayer's ability to renew them indefinitely.

The same result was reached in *Shufflebarger v. Comm'r*.[89] Under the facts of the case, the taxpayers acquired a portion of a summer allotment of grazing privileges in a national forest. They amortized the cost of acquiring the grazing privileges. The IRS disallowed the deduction on the basis that the rights had an indefinite duration. The Tax Court agreed.

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84. See Treas. Reg. §§1.168(i)-1(e)(2)(i) and (iii).
85. See Treas. Reg. §§1.168(i)-(1)(c)(1)(i) and 1.168(i)-1(e)(3)(vii).
86. Treas. Reg. §1.168-1(e)(3).
87. IRS Pub. 946, *How to Depreciate Property.*
88. *Uecker v. Comm'r,* 81 TC 783 (1983), *aff'd* 766 F.2d 909 (5th Cir. 1985).
89. *Shufflebarger v. Comm'r,* 24 TC No. 90 (1955).

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The same result was again reached in *Central Arizona Ranching Company v. Comm'r,*[90] a case involving state and federal land leases. Also, in Ltr. Rul. 8327003,[91] the IRS determined that a taxpayer's interest in a state grazing rights lease did not qualify as real property for purposes of a tax deferred exchange under IRC §1031, and was not subject to depreciation or amortization deductions under IRC §167. The IRS noted that the terms of the lease were of indefinite duration.

A change in the facts could lead to a different conclusion if those facts reveal that the life of the grazing privilege has a certain end point, such as when the rights are dependent on the supply of a natural resource that will eventually be depleted.

Earthen Irrigation Ditches and Levees

In Rev. Rul. 69-606,[92] the IRS ruled that the cost allocated to earthen watering tanks or ponds that were constructed by a prior owner on land that the buyer leased to ranchers was not recoverable through depreciation because it did not have a determinable useful life. The IRS also ruled that the buyer could not recover the allocated cost as a soil and water conservation expense. The Tax Court concluded similarly in *Wolfsen Land & Cattle Co. v. Comm'r.*[93] In that case, the taxpayer bought a ranch that had an extensive irrigation system on over 17,000 acres. The Tax Court upheld the IRS determination that the system was not depreciable because it had an indeterminant useful life. The Tax Court noted that the evidence revealed that consistently repairing the system would result in the system lasting indefinitely.

However, some cases have held dams and ponds to be depreciable if a definite useful life can be demonstrated. For example, in *Rudolph Investment Corp. v. Comm'r*,[94] earthen water tanks and dams were determined to have a 10-year useful life. In Rev. Rul. 75-151,[95] the IRS pointed out that the question of whether dams, ponds, canals, and similar structures are depreciable depends on a factual determination that the asset is actually exhausting and that such exhaustion is susceptible to measurement. For farmers and ranchers, a **current deduction** as a soil and water conservation expense under IRC §175 is available for expenditures incurred for earthen terraces and dams which are nondepreciable, assuming the qualifications for §175 are satisfied.

Permanent Pastures

Permanent pasture is generally defined as land used to grow grasses or other forage naturally or through cultivation and is not included in a crop rotation for five years or longer. Permanent pastures have been held to be depreciable as in *Johnson v. Westover*.[96] The taxpayer purchased a ranch that included 200 acres of permanent pasture planted with various grasses about five years earlier. The court determined, based on the evidence, that the pasture should be replanted at the end of 10 years to maintain its economic usefulness. At the time of purchase, the evidence showed that the pasture had a remaining life of five years.

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

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

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

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

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

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

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

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Government Allotments or Quotas

Many farmers participate in federal farm programs. Particularly under prior farm bills, farmers were required to participate in acreage allotments. An **acreage allotment** is a particular farm's share, based on its historic production, of the national acreage needed to produce sufficient supplies of a particular crop. In essence, an allotment represents the federal government's attempt to micromanage production of certain types of crops. These allotments have been held to not be depreciable due to a lack of a determinable useful life. For example, in *Wenzel v. Comm'r,*[97] the Tax Court addressed whether the peanut base acreage allotment as part of the federal farm programs was depreciable. The Tax Court noted that although the program had been controversial for some time, it continued to be reauthorized by subsequent farm bills. Thus, the Tax Court determined that the peanut program was a stable program that would continue unless Congress took action to terminate it. Because the actions of Congress were unpredictable, the Tax Court held that the peanut program base acreage allotment was indeterminant and the associated cost to the taxpayer was not depreciable. Later, the IRS noted that three additional farm bills had become law since the Tax Court's ruling in *Wenzel* and the peanut program continued.[98] That lead the IRS to conclude that the duration of the peanut program could not be determined with reasonable certainty or accuracy. Consequently, the IRS determined the peanut base acreage allotment did not have a determinable useful life and could not be depreciated.

However, a transferable right to receive a premium price for a fixed quantity of milk in accordance with a regional milk marketing order was held to be amortizable (e.g., the cost could be spread over the useful life of 15 years) when it has a statutory expiration date and is not expected to be renewed. For example, in *Van de Steeg v. Comm'r,*[99] the taxpayers were dairy farmers who marketed their milk production subject to a Federal Milk Marketing Order. On several occasions, they purchased an intangible asset (referred to as a "class I milk base") which they used in their dairy business. They claimed amortization for the milk base and the IRS disallowed the deduction on the basis that the asset had an indeterminable useful life (i.e., it depended on whether Congress extends the program.) The Tax Court, affirmed by the Ninth Circuit, held that the program that created the class I milk base always contained an express termination date and the existence of two extensions did not change the fact that a termination date always existed, even though the date had changed. Although the IRS disagreed with the *Van de Steeg* opinion, it announced that it would follow it.[100] Expenditures for milk marketing orders are amortizable costs.

Drilling Costs for Wells

Drilling costs for wells are not depreciable, but parts of wells, such as piping and casings, are.[101] However, there is language in a Treas. Reg. that indicates that wells might be depreciable.[102] In addition, the fact that the IRS has previously ruled that water wells were eligible for the investment tax credit (when it was available) bolsters the argument that water wells are depreciable. To be eligible for the investment tax credit, the property at issue had to be depreciable property.[103]

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

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

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

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

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

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

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

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Landscaping and Land Modification Costs

If a farmer or rancher incurs costs associated with landscaping or modifying the land (e.g., dirt moving) to construct a building that will be used in the farming business, the costs are likely depreciable. Under the facts of Rev. Rul. 74-265,[104] the taxpayer constructed and operated a garden-type apartment complex on several acres. The surrounding area was landscaped according to an architect's plan. The expenditures for landscaping included the cost of topsoil, seeding, clearing and grading, and planting of perennial shrubbery and ornamental trees around the perimeter of the tract of land and immediately adjacent to the buildings. The replacement of the apartment buildings after the expiration of their useful lives would destroy the immediately adjacent landscaping. The IRS ruled that the perennial shrubbery and ornamental trees immediately adjacent to the apartment buildings were depreciable because the replacement of the buildings would destroy the landscaping. That meant that the land preparatory costs could be recovered through depreciation deductions over the established useful life of the apartment buildings.

Logging Roads, Bridges, and Culverts

Logging roads, bridges, and culverts are depreciable if the taxpayer can establish that the roads have a determinable life. In one instance, the IRS ruled that a road had a determinable useful life that could be determined by the amount of time it took to harvest trees that were reachable by the road.[105] Under the facts of the ruling, the taxpayer built roads to harvest timber, to transport the logs cut from the timber to its facilities for processing, and to carry out general management activities. The taxpayer wanted to depreciate two of the roads. One road was to be maintained so the taxpayer could use it for an indefinite period to manage and harvest timber. The IRS ruled that the roadbed could not be depreciated, but that the associated surface, bridges, and culverts could be depreciated because they each had determinable useful lives. The other road was to be abandoned after four years, and the useful lives of all parts of the road (roadbed, surface, bridges, culverts, etc.) would terminate when the timber harvest and reforestation work was completed that the road was associated with. Thus, this road could be depreciated.

In a Tax Court case, the taxpayers were allowed to depreciate paved lots that were used in a cattle operation.[106] The court based its determination on the fact that the taxpayers maintained the horse barn and **associated paved areas** primarily for use in their cattle-raising activity. The horses housed in the barn were used by the taxpayers to move cattle from one pasture to another, and the Tax Court determined that the horse barn was maintained primarily for use in the cattle-raising activity which was engaged in for profit.

CORRECTING DEPRECIATION ERRORS

One of the common errors made on a tax return involves depreciation. Depreciation errors can result from, among other things, a math error, a posting error, or an incorrect method. Depreciation errors are corrected by either filing an amended return **or** filing a change in accounting method form.

BASIC PRINCIPLE

It is important to note that errors are errors and accounting methods are not "errors." **Errors** are corrected by amending returns. **Accounting methods** are changed by filing Form 3115, *Application for Change in Accounting Method*. An amended return can be filed to correct for depreciation accounting method problems (wrong method or life) **if the next year's return has not yet been filed.**

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

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

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

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AUTOMATIC CONSENT PROCEDURE

The IRS's automatic consent procedures for taxpayers who have adopted an impermissible method of accounting for depreciation (or amortization) and have either claimed no allowable depreciation, less depreciation than allowable, or more depreciation than allowable is provided in the guidance at Rev. Proc. 2015-13.[107]

> **Note.** Rev. Proc. 2019-43,[108] has the latest list of automatic consent procedures. Although several revenue procedures have been issued that modify or add to that list, Rev. Proc. 2019-43 is the latest of the full listing.

Taxpayers who qualify under the automatic procedure are permitted to change to a method of accounting under which the allowable amount of depreciation is claimed. The unclaimed depreciation from years before the year of change is considered as a **net negative adjustment** in the year of change and are **deducted in full** on the return for the year of change.

THE 2-YEAR RULE [109]

The use of an incorrect method of depreciation is considered the use of an incorrect accounting method. Once an incorrect accounting method has been used for two years, **Form 3115 is required to change accounting methods back to a correct method, or to begin taking depreciation.**

> **Note.** If no depreciation had been taken and only one year has passed, the return may be corrected via an amended return because the incorrect method had only been used for one year.

AMENDED RETURNS[110]

A depreciation error that is not subject to the accounting method change filing requirements should be corrected via an amended return in the following situations.

- The incorrect amount of depreciation was claimed due to a mathematical error made in any year.
- The incorrect amount of depreciation was claimed due to a posting error made in any year.
- An incorrect amount of depreciation was claimed on property placed in service in tax years ending before the statute of limitations expired (but not due to an established accounting method).
- The amount of expense method depreciation (IRC §179) is being changed.
- An election is being made to apply the $2,500/$5,000 de minimis safe harbor rules (within its own time period requirements of return due date plus extension).

> **Caution.** If the election out of bonus depreciation was not made, the accounting method change provisions apply, and an amended return cannot be filed if two years have passed. If only one year, the taxpayer has a choice of amending the return or proceeding under the rules governing a change in accounting method. But filing an amended return may not be an option for a partnership. If bonus depreciation was taken, a change to elect out may only be made via a superseding return.[111]

107. Rev. Proc. 2015-13, 2015-5 IRB 419.
108. Rev. Proc. 2019-43, 2019-48 IRB 1107.
109. IRM 4.11.6 (2021).
110. Treas. Reg. §1.446-1(e).
111. Rev. Proc. 2019-43, 2019-48 IRB 1107.

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Amending returns will only correct depreciation errors that have occurred in the last three years. Errors that have occurred before that cannot be "caught up" on current or amended returns and will only be "caught up" when the asset is sold using a Form 3115 and designated change number (DCN) 107. These errors must be from applying impermissible accounting methods.

CHANGE IN ACCOUNTING METHOD — FORM 3115

As mentioned previously, Form 3115 is used to correct depreciation if the correction relates to the misapplication of an accounting method, including the omission of depreciation. When depreciation for an asset is inadvertently left off the return, the IRS treats the omission as the adoption of an **incorrect method of accounting** if the subsequent year's return has been filed. Thus, the correction of the omission may only be made by the filing of Form 3115.

> **Note.** When changing methods of accounting from not taking depreciation (incorrect method) to taking depreciation (correct method), DCN 7 should be entered on Form 3115 if the asset is still in use, or DCN 107 if disposed.[112]

One Form 3115 may be used to correct mistakes on more than one asset.[113]

Form 3115 Required[114]

The following depreciation changes constitute a change in accounting method and a Form 3115 must be filed.

- Changing from not taking depreciation to taking depreciation (a change from an impermissible method to a permissible method) (DCN 7 on Form 3115)
- Corrections in methods or conventions (DCN 7 on Form 3115)
- Changes from a permissible method to another permissible method (DCN 8 on Form 3115)

> **Note.** Generally, there is only one permissible recovery period. If the taxpayer used the wrong recovery period, it is a change from impermissible to permissible. For a taxpayer with multiple assets that need to be changed, DCN 200 on Form 3115 should be used.

- Correcting depreciation on leasehold improvements from using the incorrect life of the lease term to the correct life of the asset (usually 15 or 39 years) (DCN 199 on Form 3115)

> **Note.** Rev. Proc. 2015-13 is also to be used to correct depreciation after an asset has been sold.

Rev. Proc. 2015-13 allows a taxpayer to recover depreciation deductions that have been mistakenly overlooked, for which, under the "allowed or allowable" rule the taxpayer had to reduce basis in the asset, effectively making the "allowed or allowable" penalty disappear. DCN 107 on Form 3115 should be used to "catch up" omitted depreciation on an asset when it is sold.

> **Note.** For more an extensive example on Form 3115, including completed forms, see the 2015 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: Depreciation. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

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112. See Instructions for Form 3115 for a list of DCNs.

113. Rev. Proc. 2015-13, 2015-5 IRB 419.

114. See Instructions for Form 3115.

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Form 3115 Not Required[115]

Depreciation changes that **do not require** Form 3115 because they are not considered changes in an accounting method may only be made on an amended return and include the following.

- A change in computing depreciation because of a change in the use by the same taxpayer
- A change in placed-in-service date
- A change in useful life
- Making a late depreciation election or revoking a timely valid depreciation election

Note. A change from not claiming bonus depreciation to claiming bonus is a revocation of the election and is not an automatic accounting method change. This change requires IRS advance consent to change an election.

Procedural Aspects[116]

Form 3115 is filed to correct the accounting method for depreciation. The total depreciation adjustment, an IRC §481 adjustment, is **deducted in full in the year of change if it is negative.** If the adjustment is **positive, it must be added in ratably over four years.** However, if the adjustment is positive but less than $50,000 in total, the taxpayer may elect to add it in to income in full in the year of change.

Form 3115 may be filed at any time for any year. If it is filed for an asset that was sold in a prior year, the taxpayer should use DCN 7 on page one of Form 3115 if the taxpayer still owns the asset. If the asset was sold during the year, the applicable DCN is 107.

Filing Requirements.[117] A signed copy of Form 3115 must be filed with the IRS. No advance approval is required to correct the error, as this is an automatic approval change in most cases. There is no user fee.

The original Form 3115 should be filed with the tax return for the year of change. The original must be filed by the due date of the return, plus extension. There is a 6-month automatic extension of the due date if the return was timely filed, and an amended return (with this change) is filed within six months.

When filing Form 3115, the additional statements listed below must be attached.

- A detailed description of the former and new methods of accounting
- A statement describing the taxpayer's business or income-producing activities
- A statement of the facts and law supporting the new method of accounting, new classification of the item of property, and new asset class
- A statement identifying the year in which the item of property was placed in service

115. Rev. Proc. 2019-43, 2019-48 IRB 1107.

116. Ibid.

117. See Instructions for Form 3115.

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TCJA AND BONUS DEPRECIATION[118]

TCJA increased the additional first-year bonus depreciation deduction from 50% to 100%. In addition, the property eligible for bonus depreciation was expanded to include certain used depreciable property and certain film, television, or live theatrical productions. Also, the placed-in-service date was extended to before January 1, 2027, and the date on which a specified plant is planted or grafted by the taxpayer was extended to before January 1, 2027.

The TCJA created three additional first-year depreciation deduction elections.

1. A taxpayer can elect not to deduct the additional first-year depreciation for all qualified property that is in the same class of property and placed in service by the taxpayer in the same tax year.
2. Instead of 100%, a taxpayer can elect to deduct 50% additional first-year depreciation for all qualified property acquired after September 27, 2017, and placed in service by the taxpayer during its taxable year that includes September 28, 2017.
3. A taxpayer can elect to deduct additional first-year depreciation for any specified plant that is planted after September 27, 2017, and before January 1, 2027, or grafted after and before those dates to a plant that has already been planted. If the taxpayer makes this election, the additional first-year depreciation deduction is allowable for the specified plant in the taxable year in which that plant is planted or grafted.

S CORPORATION DISSOLUTION

The S corporation as an entity choice for the operating part of a farming or ranching business has waned over the years in favor of the general partnership (for larger operations) or the limited liability company (LLC). For farm businesses large enough to qualify for more than one government farm program payment limit, a partnership will allow qualification. An S corporation is limited to a single payment limit.[119] Another drawback of the S corporation is the adverse impact upon the death of a shareholder. That adverse impact is shown in the fact that the heirs of the deceased shareholder do not get the benefit of a step-up in basis in the underlying corporate assets to FMV as of the date of the shareholder's death.[120] Unlike a partnership where the heirs receive a full income tax basis increase for all the underlying partnership assets, an heir of an S corporation shareholder only receives a basis increase in the corporate stock equal to the FMV of the S corporation at death.[121] The increased basis at death for an S corporation shareholder reduces gain upon disposition of the stock, and does not provide current deductions via depreciation as with a partner.

SHAREHOLDER DEATH AND CORPORATE LIQUIDATION

Upon the death of an S corporation shareholder, the decedent's stock ownership interest receives a step-up in basis to FMV. This basis adjustment coupled with the basis increase that results from gain recognition inside the corporation upon liquidation of corporate assets (e.g., sale/distribution of assets, real estate, etc.) and the pass-through of the taxation of this gain to the shareholder (on Schedule K-1 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credits, etc.),* results in only one level of taxation being incurred on liquidation, and that is at the shareholder level.[122]

Because stock basis has been increased by death and pass-through of income, **no gain recognition results when cash or property is distributed to the decedent's estate/heirs (in exchange for stock) to complete the liquidation,** because the pass-through gain to the estate/heirs is offset by a matching loss from liquidation of the stock.[123]

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118. *Additional First Year Depreciation Deduction (Bonus) FAQ.* IRS. [www.irs.gov/newsroom/additional-first-year-depreciation-bonus-faq] Accessed on Aug. 12, 2022.

119. Farm Service Agency Handbook, 1-PL, Revision 1, Para, 313 A.

120. IRC §1367(b)(4).

121. Ibid.

122. Treas. Reg. §1.1367-1.

123. Ibid.

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Example 9. Kelly owns 100% of KG Corp. (S corporation). The only asset in KG Corp. is equipment with a FMV of $100,000 and income tax basis of $0. Her stock basis is $20,000. After her death, Roger is the sole heir to the S corporation stock. Roger's stepped-up stock basis is $100,000. The equipment is sold for $100,000 and the corporation reports net income of $100,000 that is allocated to Roger on Schedule K-1. This recognition of income causes Roger's stock basis to increase to $200,000.

In the same tax year, Roger dissolves the corporation by taking a distribution of $100,000. This causes a loss on the stock liquidation of $100,000. While the stock loss amount equals the income allocation; the stock loss is subject to capital loss limitations.

Observation. If the income from asset sales was capital gain, the same year liquidation stock loss would fully offset the capital gain.

Property Distributions

Distributions of property (other than cash) are treated as though the corporation sold the property to the shareholder for its FMV, pursuant to IRC §311(b). The corporation recognizes gain to the extent the property's FMV exceeds its adjusted basis. When appreciated property is distributed to an S corporate shareholder in exchange for stock, the gain recognized at the corporate level passes through to **all** shareholders (via Schedule K-1) based on their percentage ownership in the corporation.

If the S corporation **only** had **one shareholder** whose interest is liquidated at death, gain recognition does not cause taxation problems due to a matching loss offset resulting from the stock basis adjustments discussed previously. In other words, when the S corporation recognizes taxable gain, that gain increases the estate's basis in the stock in an amount equal to the taxable gain that the S corporation recognizes. This taxable gain is reported to the estate on the corporation's final Schedule K-1 (Form 1120-S). The estate's tax basis in its S corporation stock is increased to the FMV of the S corporation's stock upon the shareholder's death and is further increased as a result of the deemed sale of the S corporation stock upon liquidation. Simultaneously, the estate recognizes a taxable loss equal to the gain reported to the estate on the corporation's final Schedule K-1. The loss on the deemed sale of the S corporation stock in the liquidation is reported on the estate's or heir's Schedule D, *Capital Gains and Losses,* for either Form 1040, *U.S. Individual Income Tax Return,* or Form 1041, *U.S. Income Tax Return for Estates and Trusts.* Typically, the S corporation gain on the Schedule K-1 (Form 1120-S) is reported on Schedule E, *Supplemental Income or Loss,* (Form 1040 or Form 1041) and the loss on the Schedule D will net out with no tax due by the estate or the heirs for the S corporation gain on liquidation. This is only true when taxable income is characterized as capital gain.

Caution. In some instances, a farming S corporation may have one spouse as a shareholder and own ordinary income assets such as grain and equipment. Upon the shareholder's death with the corporate stock passing to the surviving spouse, the sale of those assets by the surviving spouse will trigger ordinary income to the surviving spouse that are taxed at the highest rate. If the surviving spouse then liquidates the S corporation, a capital loss is triggered in a like amount but is subject to capital loss limitations of $3,000 per year (or offset against other capital gains).

Note. The business now has a new stepped-up basis for assets that the heirs can contribute tax-free to a new partnership.

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However, if the S corporation has **more than one shareholder,** a distribution of property to a single shareholder (deceased or otherwise) in liquidation of their stock interest results in a taxation event for **all** corporate shareholders.

Example 10. Farm Corp. has four equal shareholders. Mary, a shareholder who owns 25% of the S corporation's stock, dies. The corporation distributes farm real estate to Mary's estate in liquidation of her stock interest. Mary's estate would report 25% of any gain at distribution and would be able to offset this taxable gain through a matching capital loss created by the liquidation of her stock in Farm Corp. Unfortunately, the other shareholders are responsible for paying tax on the remaining 75% of any gain.

Note. An alternative to avoid this taxation problem when there are multiple shareholders in an S corporation is to have the remaining shareholders purchase the stock of the deceased shareholder. Implementing a corporate buy-sell agreement among the shareholders might be advantageous to accomplish the desired result.

A shareholder's income tax basis in property distributed by the corporation is the property's FMV at the date of distribution. **However, the distributee shareholder's holding period begins when the shareholder actually or constructively receives the property,** because the distribution is treated as if the property were sold to the shareholder at its FMV on that date. Because the shareholder's basis in the property is its FMV (rather than a carryover of the corporation's basis), the corporation's **holding period does not tack on** to the shareholder's holding period. Thus, the redeeming shareholder would need to hold distributed property for one year after distribution prior to sale to achieve capital gain income tax treatment on a subsequent sale.

Alternative to Liquidation — Divisive Reorganization

An alternative to liquidating a corporation (S or C) at the death of the surviving spouse is a divisive reorganization under IRC §355. In a divisive reorganization, part of the assets of a parent corporation are split-off to one or more (former) shareholders through a new corporation. A divisive reorganization typically involves three major steps.

1. Formation of a new subsidiary corporation
2. Transfer of part of the parent corporation's assets to the subsidiary (usually tax-free)
3. Distribution of the stock in the subsidiary to some of the parent corporation's shareholders in exchange for their stock in the parent corporation

A divisive reorganization can be used to divide a single, functionally integrated business (e.g., farming operation) into two separate businesses and allows surviving shareholders to postpone income recognition that would otherwise occur through corporate liquidation at the death of the first-generation shareholders.[124]

For a divisive reorganization to be tax-free, **five tests** under §355 must be met.

1. Control test
2. Active conduct of a business test
3. Distribution of solely stock or securities
4. Parent corporation must distribute all the stock in the subsidiary (or enough for control)
5. Reorganization must not be used primarily as a device for distribution of earnings and profits

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[124] Treas. Regs. §§1.355-1(b) & 1.355-3(c), Examples 4 & 5. See also, Rev. Rul. 75-160, 1975-1 CB 112; *Coady v. Comm'r*, 33 TC 771 (1960), *acq.,* 1965-2 C.B. 4, *non. acq.,* 1960-2 CB 8 (withdrawn), *aff'd.* 289 F.2d 490 (6th Cir. 1961); *U.S. v. Marett,* 325 F.2d 28 (5th Cir. 1963).

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Although there are technically five tests that must be satisfied for a divisive reorganization to be tax-free, in reality, only two of the tests generally create issues that could prevent a reorganization from being utilized. The two problematic requisites/tests are the active conduct of trade or business requirement and the stock distribution requirement for a trade or business purpose.

Active Conduct of Trade or Business. For purposes of §355, a trade or business must have been actively conducted by the distributing parent corporation throughout the 5-year period ending on the date of distribution. The regulations under §355 expand this requirement and require continued operation of the business or businesses existing before the implementation of the divisive reorganization. Accordingly, a transitory continuation of one of the active businesses does not satisfy the active trade or business test provided by these regulations.[125] This requirement causes advance planning prior to executing this strategy.

The following is guidance on the active trade or business requirement.

- The holding of stock and securities for investment purposes does not constitute the active conduct of a trade or business. Also, the ownership and rental of real or personal property (e.g., farm real estate) does not constitute the active conduct of a trade or business unless the owner performs significant services with respect to the operation and management of the property.[126]
- Rev. Rul. 73-234[127] involved a corporate farming operation where the active conduct of a trade or business test was satisfied. The facts involved a livestock share lease with active involvement. The IRS states:

  > *The fact that a portion of a corporation's business activities is performed by independent contractors will not preclude the corporation from being engaged in the active conduct of a trade or business if the corporation itself directly performs active and substantial management and operational functions.*

- The active conduct of a trade or business test was not met in Rev. Rul. 86-126.[128] The facts involve a corporation that cash-rented farmland. There was a sharing of expenses. The tenant planted, raised, harvested, and sold the crops using the tenant's equipment. The activities of the corporate officers in leasing the land, providing advice, and reviewing accounts were determined to not be substantial enough to meet the active trade or business requirement.

Note. It does **not** appear that the use of a farm manager (agent) to perform these services for the corporation necessarily impairs the active conduct of a trade or business requirement. However, the officers and directors must be active in directing the activities of the agent, not mere spectators.[129]

125. IRC §355(b)(1)(A) and Treas. Reg. §1.355-3(a)(1).

126. Treas. Reg. §1.355-3(b)(2)(iv).

127. Rev. Rul. 73-234, 1973-1 CB 180.

128. Rev. Rul 86-126, 1986-2 CB 58.

129. *Webster Corp. v. Comm'r,* 25 TC 55 (1955), *aff'd* 240 F.2d 164 (2d Cir. 1957), *acq.,* 1960-2 CB 7.

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Practitioner Planning Tip

The activities of the corporation's officers and directors for the pre-distribution (five years) and post-distribution (two or more years) time frames should be well documented before a divisive reorganization is undertaken. Also, payment of at least nominal officer/director salaries for services performed should be considered.

Trade or Business Purpose. Treas. Reg. §1.355-2(b)(2) provides that a **corporate business purpose** must be a real and substantial nonfederal tax purpose germane to the business of the distributing corporation, **as well as** the controlled corporation. A **shareholder purpose** (i.e., accomplishing personal estate planning objectives) by itself, is **not** a corporate business purpose. However, the regulations go on to explain that a shareholder purpose may be so nearly co-extensive with a corporate business purpose as to preclude any distinction between them, in which case the transaction meets the corporate business purpose requirement. **A transaction motivated in substantial part by a corporate business purpose will not fail the business purpose requirement merely because it is motivated in part by nonfederal tax shareholder purposes.**

Note. Within this guidance, the business purpose test generally is readily ascertainable (e.g., shareholder disputes or potential therefore, etc.).

The following examples show the IRS' position on valid trade or business purposes for divisive reorganizations.

- Rev. Rul. 2003-52[130] involved a family farming corporation that the parents and their two adult children owned. The children provided active management. One child intended to focus on the livestock side of the business while the other child preferred to operate the grain farming operation. The corporation reorganized into two corporations, with one child receiving the stock of the livestock business and the other child receiving the stock of the grain enterprise. The IRS approved the reorganization on the basis that it was motivated by a substantial nontax business purpose even though the reorganization advanced the personal estate planning goals of the parents and promoted family harmony.
- Ltr. Rul. 200323041[131] involved the separation of a grain farming business between siblings after their father's death. The IRS concluded that a corporate split-off undertaken to avoid shareholder disputes in a family-owned grain farming corporation (engaged in a single line of business) will constitute a divisive reorganization under IRC §368(a)(1)(D) and the stockholders of the split-off corporation would not recognize gain or loss under §355.[132]

Note. The IRS has ruled that the post-distribution business purpose requirement of Treas. Reg. §1.355-2(b) remained satisfied even though the business purpose could not be achieved due to an unexpected change in circumstances following the divisive reorganization. In so ruling, the IRS noted that the "regulations do not require that the corporation in fact succeed in meeting its corporate business purpose, as long as, at the time of the distribution, such a purpose exists and motivates, in whole or substantial part, the distribution."[133]

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130. Rev. Rul. 2003-52, 2003-1 CB 960.

131. Ltr. Rul. 200323041 (Mar. 11, 2003).

132. See, also Ltr. Rul. 200425033 (Mar. 4, 2004) and Ltr. Rul. 200422040 (Feb. 13, 2004).

133. Rev. Rul. 2003-55, 2003-1 CB 961.

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Other Considerations. Although §355 requires that the corporation seeking a divisive reorganization be engaged in the active conduct of a trade or business, it does not require that all the assets of the corporation be devoted to or used in an active trade or business. The corporation may hold nonqualifying assets (generally less than 5% of total) as long as it is engaged in the active conduct of a trade or business.[134]

Practitioner Planning Tip

It may be advisable to have all shareholders enter into an agreement, providing that any shareholder who violates the post-distribution active trade or business rule agrees to pay **all** taxes incurred by all shareholders if the divisive reorganization fails to pass IRS scrutiny.

Note: In Rev. Proc. 2003-48,[135] the IRS stated that, for ruling requests after August 8, 2003, it would no longer rule on whether:

1. A distribution of stock of a controlled corporation is carried out for business purposes,
2. The transaction is used principally as a device, or
3. A distribution and an acquisition are part of a plan under §355(e).

Rather, taxpayers seeking a ruling under §355 must submit representations on these issues for review and determination by IRS.

Fortunately, certain planning steps can be taken to avoid the heirs being denied the benefit of a basis increase in the corporate assets to FMV at death. Those steps include liquidating the S corporation; liquidation via a merger; and conversion of the S corporation to a partnership.

Note. For more information on liquidating an S corporation, see the 2022 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Terminating a Business Interest.

CAPTIVE INSURANCE

Many businesses, including farming and ranching businesses, face rising insurance costs and higher self-insured risks for hazards. This is particularly true for many agriculture businesses that face ever-increasing environmental rules and regulations that can impair operational profitability, heightened cyber threats, as well as supply chain and labor issues. As a result, some of these businesses have begun to investigate and utilize captive (and micro-captive) insurance.[136]

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134. Treas. Reg. §1.355-3(a)(ii).

135. Rev. Proc. 2003-48, 2003-2 CB 86.

136. See, e.g., *Once Scrutinized, an Insurance Product Becomes a Crisis Lifeline*. Sullivan, Paul. Mar. 20, 2020. The New York Times. [www.nytimes.com/2020/03/20/your-money/coronavirus-insurance-small-business.html] Accessed on Jul. 16, 2022.

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CAPTIVE INSURANCE DEFINED

A captive insurance company is an insurer that is a wholly owned subsidiary providing risk-mitigation services for its parent company or a group of related companies.[137] A key to being a true captive insurance company is the provision of risk-mitigation. Often, the reason for forming a captive insurance company is when a business (the parent company) is unable to find standard commercial insurance to cover risks that are unique to the business. Without the creation of a captive insurance company, the business is left to self-insure against risks for which it is unable to acquire commercial insurance. In this situation, a captive insurance company provides the ability to shift self-insured risks to the captive company with policies tailored to fit the parent's unique needs. The owners of the parent can retain control of the captive's investments and may also be able to achieve tax savings and wealth transfer benefits.

INCOME TAX ASPECTS

Caution. While a captive insurance strategy can be successfully designed for insurance purposes, caution is needed if only seeking income tax benefits from generating premiums that become tax-free.

An insurance transaction is one that involves an actual insurance risk and involves risk-shifting and risk-distributing.[138] Insurance premiums are deductible as an ordinary and necessary business expense under IRC §162(a) if paid or incurred in connection with the taxpayer's trade or business.[139] However, amounts set aside in a loss reserve as a form of self-insurance are not deductible.[140] As Judge Holmes stated in *Caylor Land & Development, Inc. v. Comm'r,*[141] "the line between nondeductible self-insurance and deductible insurance is blurry, and we try to clarify it by looking to four nonexclusive but rarely supplemented criteria: risk-shifting; risk-distribution; insurance risk; and whether an arrangement looks like commonly accepted notions of insurance."

On the other side, an insurance company includes premiums that it receives in income, and the company is generally taxed on its income just like any other taxpayer.[142] But a captive insurance company that receives premiums below a certain amount during a tax year can elect to be taxed only on investment income.[143]

Note. For premiums paid to be deductible, the captive must be respected as an insurance company for federal income tax purposes. Otherwise, it is considered nondeductible self-insurance. This means qualified underwriting services must be used to determine the actual cost of similar coverage in the market or via an underwriting evaluation so that the policies are properly designed, and the premiums are appropriate. This is key to getting the desired tax treatment and withstanding an IRS criticism. Setting premiums too high coupled with claims that are less than anticipated will cause the captive's stock value to rise. That value can be returned to shareholders in a tax-favorable manner as qualified dividends taxed at favorable capital gain rates. Hence, the importance of the proper structuring of the captive to avoid an IRS examination and the imposition of severe penalties (explained later).

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137. *Avrahami vs. Comm'r,* 149 TC 7 (2017).

138. *Helvering v. Le Gierse,* 312 U.S. 521 (1941).

139. Treas. Reg. §1.162-1(a).

140. See, e.g., *Harper Group v. Comm'r,* 96 TC 45 (1991), *aff'd* 979 F.2d 1341 (9th Cir. 1992).

141. *Caylor Land & Development, Inc. v. Comm'r,* TC Memo 2021-30 (Mar. 10, 2021).

142. IRC §831(a).

143. IRC §§831(b)(1)-(2).

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ESTATE AND BUSINESS PLANNING ASPECTS[144]

Before Congress modified IRC §831, the captive or micro-captive corporation could fit rather easily into an estate or succession plan and could be held in various types of entities depending upon the overall estate and business plan of the owner(s). A straightforward approach, for example, was to have a parent(s) form a captive insurance company and name the children as the shareholders. As the parents paid the premiums, they achieved insurance coverage for their unique need(s) and transferred wealth to the children. Establishing the captive, however, must be justified by a legitimate business purpose of insuring risks of the business other than simply transferring wealth in a tax-efficient manner to the children.

Trust Ownership

A trust could be established to own the captive insurance company. If the trust's beneficiaries are the grantor's children and/or grandchildren, it is possible to structure the trust such that the assets of the captive insurance corporation will not be included in the owner's estate at death.

LLC and Family Limited Partnership Ownership

Similarly, the captive corporation could be placed in an LLC or a family limited partnership (FLP). The ownership structure of the LLC or FLP could involve various classes of ownership held by various members of the owner(s) family. This structure may be especially beneficial in the context of a small businesses such as a farm or ranch where the senior generation wants to maintain control over the business, investments, and distributions of the captive insurance corporation while simultaneously setting up valuation discounts for minority interest and/or lack of marketability.

Gift Tax

From a federal gift tax standpoint, income tax deductible premiums made for adequate and full consideration are not a gift from the owners of the insured to the owners of the captive insurance company.[145] The **full and adequate consideration** test of IRC §2512 applies in the estate tax context such that the premium payments are not pulled back into the decedent/transferor's estate at death for federal estate tax purposes under §§2036 or 2038. This also means that the generation-skipping transfer tax would not apply.

Statutory Modifications

In late 2015, Congress passed "extender" legislation[146] that included new rules impacting certain captive insurance companies. Under the new rules, effective for tax years beginning after 2016, the maximum amount of annual premiums that a captive insurance company may receive is capped (subject to an inflation adjustment). The cap is $2.45 million for 2022.[147] In addition, a captive insurance company must satisfy one of two **diversification tests** that bear directly on the ability to transfer wealth to the next generation without transfer tax. Under this requirement, the ownership of the underlying business of the captive must be within 2% of the ownership of the captive. The new rule applies to all §831(b) captive insurance companies regardless of when formed.

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144. IRC §831(b).

145. Treas. Reg. §§25.2512-1(g)(1) and 25.2512-8.

146. *Protecting Americans from Tax Hikes (PATH) Act of 2015,* as included in the *Consolidated Appropriations Act of 2016,* PL 114-113, Div. Q.

147. Ibid, §333.

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Under revised §831(b), a captive that makes a §831(b) election must satisfy one of the following two requirements designed to prevent it from being used as a wealth transfer tool (the second requirement is written in the negative — the captive must **not** satisfy it).

1. No more than 20% of the net written premiums (or, if greater, direct written premiums) of the company for the tax year is attributable to any one policyholder.

Note. IRC §831(b) was retroactively amended by the Consolidated Appropriations Act of 2018 (CAA) such that "policyholder" means "each policyholder of the underlying direct written insurance with respect to such reinsurance or arrangement." Thus, a risk management pool itself is **not** considered to be the policyholder. Each insured person paying premiums into the pool is considered a policy holder. As long as none of those insured persons account for more than 20% of the total premiums paid to the captive, the 20% test is satisfied.[148]

2. The captive company does not meet the 20% requirement **and** no person who holds (directly or indirectly) an interest in the company is a spouse or lineal descendant of a person who holds an interest (directly or indirectly) in the parent company who holds (directly or indirectly) aggregate interests in the company which constitute a percentage of the entire interests in the company which is more than a 2-percentage higher than the percentage interests in the parent company with respect to the captive held (directly or indirectly) by the spouse or lineal descendant.[149]

Note. Essentially, the second requirement means that if the spouse or lineal descendants' ownership of the captive company is greater than 2% of their ownership of the parent company, the second requirement is not satisfied.

The CAA modified the second test to eliminate spouses from the definition of specified holder unless the spouse is not a U.S. citizen. Thus, the ownership test only applies to lineal descendants of either spouse, spouses who are not U.S. citizens, and spouses of lineal descendants.[150] The CAA also added a new aggregation rule to apply to certain spousal interests such that any interest held, directly or indirectly, by the spouse of a specified holder is deemed to be held by the specified holder. In addition, the CAA modified the ownership test to look at the aggregate amount of an interest in the trade, business, rights, or assets insured by the captive, held by a specified holder, spouse, or specified relation.[151] The rule excludes assets that have been transferred to a spouse or other related person by bequest, devise, or inheritance from a decedent during the taxable year of the insurance company or the preceding tax year.[152]

Thus, in the estate/succession planning context, if a parent (i.e., father or mother) or parents are the sole owner(s) of the parent company and the captive company, the captive company can make the §831 election. That is because no lineal descendant has any ownership in the captive company. But, if a parent(s) is (are) the sole owner of the parent company and the children own the captive company, the captive cannot make the §831 election because 100% is more than 2% higher than their 0% interest in the parent company. The result is the same if the captive is held (indirectly) in a trust with the children as the beneficiaries. But, if the parent owns half of the parent company and half of the captive company with the children owning the other half of each entity, the captive company **can** make the §831 election.

Note. If the children meaningfully own the parent company, they can own the captive company. The converse is also true.

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148. IRC §831(b)(2)(D).
149. IRC §831(b)(2)(B).
150. IRC §831(b)(2)(B)(iii).
151. IRC §831(b)(2)(B)(iv)(I).
152. Ibid.

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Given the modifications to §831(b), it remains possible to use a captive insurance company as part of an estate/business succession plan if the ownership of the parent and the captive is structured properly with the appropriate ownership percentages in both the parent and captive business entities. For example, a captive company could be capitalized with cash from an intentionally defective grantor trust (IDGT) that has been established for the benefit of a child.

The gift of funds to the IDGT is a completed gift for federal gift tax purposes and removes that value from the grantor's estate at death. The income that the IDGT receives from the captive is taxed to the grantor, and the grantor deducts the premiums paid to the captive company and reports the net profits from the captive as a qualified dividend. That is the case even though the cash flows from the parent company (the family business) to the captive insurance company and then to the IDGT and then on to the grantor's child/children. But, again, the ownership percentages of the parent and the captive insurance company must be carefully structured to stay within the borders of §831.

As an alternative, as noted previously, the captive insurance company could be held in an FLP and the parents could gift FLP interests to the children annually consistent with the present interest annual exclusion (currently $16,000 per donee per year (spouses can elect "split-gift" treatment)). Each FLP interest entitles the owner to a share of the captive company's profits. It may also be possible for the parents to claim valuation discounts on the gifts of interests in the FLP. But, of course, the percentage ownerships of the parent company and the captive must stay within the "guardrails" of §831.[153]

IRS SCRUTINY, LITIGATION, AND OTHER DEVELOPMENTS

Abusive micro-captive corporations have been a concern to the IRS for several years. The basic issue is where the line is between deductible captive insurance and nondeductible self-insurance.

> **Note.** The IRS scrutiny centers on the fact that with a §831(b) election, premiums can be deducted at ordinary income rates and can then be distributed to owners at more favorable capital gain rates. To the extent claims are not paid, the premiums can be distributed from the captive in a manner that escapes transfer taxes. Both of these issues, in turn, are centered on whether the captive company is insuring legitimate business risks and that "insurance" is actually involved.

IRS Audits

The IRS initiated forensic audits of large captive insurance providers at least a decade ago, and the IRS activity resulted in certain transactions making the "Dirty Dozen" tax scam list starting in 2014. In 2015, the IRS put out a news release that notified taxpayers that it would be acting against micro-captive insurance arrangements that it believes are being used to evade taxes.[154] In 2016, the IRS identified certain micro-captive transactions as having the potential for tax avoidance and evasion.[155] Since that time, the IRS has been litigating the micro-captive insurance issue aggressively.

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153. IRC §831(b).

154. IRS News Rel. IR-2015-16 (Feb. 3, 2015).

155. IRS Notice 2016-66, 2016-47 IRB 745.

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Court Cases

Taxpayers have won court cases involving IRS challenges to the tax treatment of and deductions associated with captive insurance companies. The wins involved large captive insurance companies. For instance, in *Rent-A-Center v. Comm'r,*[156] the Tax Court determined that payments a subsidiary corporation made to a captive insurance company were insurance expenses deductible under §162. Likewise, in *Securitas Holdings, Inc. v. Comm'r,*[157] the Tax Court determined that premiums paid to a brother-sister captive insurance company were deductible. Also, in *R.V.I. Guaranty Co. Ltd. and Subs v. Comm'r,*[158] the Tax Court held that insuring against losses in the residual value of an asset leased to third parties was insurance for federal income tax purposes.

> **Note.** Importantly, in each of the cases involving taxpayer wins, the Tax Court determined that actual "insurance" was involved.

But, the IRS has won several prominent cases since ramping up its scrutiny. In *Avrahami v. Comm'r,*[159] the petitioners (a married couple) owned three shopping centers and several jewelry stores in Arizona. Through these businesses, they deducted about $150,000 in insurance expenses in 2006. The petitioners then formed a captive insurance company under the law of the Federation of Saint Kitts and Nevis. After the captive insurance company was formed, their deductible insurance expenses for the companies increased to over $1.1 million annually and included coverage for terrorism risks and tax liabilities from an IRS audit.

The Tax Court upheld the IRS determination that the expenses were nondeductible and that the elections the micro-captive company made under IRC §§953(d) and 831(b) were invalid because the micro-captive company did not qualify as a legitimate insurance business. The Tax Court noted that proper policy language, actuarial standards, and payment and processing of claims are required to operate as an insurance company. These features were lacking. In addition, the Tax Court determined that there was inadequate risk distribution, and the actuary did not have any coherent explanation of how he priced the insurance policies. Also, there had been no claims filed until two months **after** the IRS initiated an audit. In addition, a majority of the investments of the micro-captive were in long-term illiquid and partially unsecured loans to related parties – the petitioners' other entities. This left a small amount of liquid funds from which to pay claims. All these facts indicated to the Tax Court that the captive was not a legitimate insurance company.

> **Note**. It is important that the captive insurance company was established to reduce or insure against risks, and not just to achieve tax benefits. In addition, policies must be appropriately priced relative to commercial insurance. The payment of excess premiums annually for several years while few or no claims are made weighs against a finding of a legitimate business purpose for creating the captive.

The next year, in *Reserve Mechanical Corp. v. Comm'r,*[160] the Tax Court disallowed deductions for insurance premiums based largely on the same reasoning utilized in *Avrahami.* The case involved an Idaho company engaged in manufacturing and distributing heavy machinery used for underground mining. Its business activities were heavily regulated and subject to potential liability risk under various state and federal environmental laws. To minimize the risk from its business operations in a more cost-effective manner, the owner(s) formed a captive insurance company under the laws of Anguilla, British West Indies to provide itself with an excess pollution policy. The captive company also provided other policies covering business cyber risk.

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156. *Rent-A-Center v. Comm'r,* 142 TC 1 (2014).
157. *Securitas Holdings, Inc. v. Comm'r,* TC Memo 2014-225 (Oct. 29, 2014).
158. *R.V.I. Guaranty Co. Ltd. and Subs v. Comm'r,* 145 TC 209 (2015).
159. *Avrahami v. Comm'r,* 149 T.C. 144 (2017).
160. *Reserve Mechanical Corp. v. Comm'r,* TC Memo 2018-86 (Jun. 18, 2018).

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The Tax Court held that the micro-captive company was not a legitimate insurance company because its transactions were not "insurance transactions." The Tax Court also determined that the micro-captive did not qualify as a domestic corporation. As such, the Tax Court upheld the IRS' determination that the company was subject to a 30% tax under IRC §881(a) on fixed or determinable annual or periodical income the company received from U.S. sources. Therefore, the Tax Court determined that the income was not effectively connected with the conduct of a U.S. trade or business.[161]

In *Syzygy Insurance Co. v. Comm'r,*[162] the petitioners had a family business that manufactured steel tanks. Annual revenue averaged about $55 million. The business obtained policies from a captive insurance company, but the arrangement did not resemble insurance transactions. The Tax Court noted that for a company to make a valid §831(b) election, it must transact in insurance. As noted previously, if insurance is actually involved, premiums paid are deductible. The Tax Court analyzed the policies and concluded that there was no risk distribution and the arrangement was not "insurance" in the commonly accepted sense of the term. Thus, the premium payments were not deductible. They were neither fees nor payments for insurance. The Tax Court also noted that the president of the family business had sent an email stating that one of the reasons for leaving the previous insurance arrangement was the decrease in premiums. Judge Ruwe wrote, "It is fair to assume that a purchaser of insurance would want the most coverage for the lowest premiums… The fact that [the president] sought higher premiums leads us to believe that the contracts were not arm's-length contracts but were aimed at increasing deductions."

Note. To reiterate, business deductions must have a business purpose, and not be solely for the purpose of lowering income tax liability.

In early 2021, the Tax Court decided *Caylor Land & Development, Inc.v. Comm'r.*[163] In *Caylor*, the petitioner was a construction company. The petitioner's $60,000 annual insurance cost was deemed to be too high. Beginning in late 2007, the company took out policies from a related micro-captive company formed under the laws of Anguilla. Doing so caused the petitioner's insurance bill to increase to about $1.2 million. The petitioner paid $1.2 million to the captive insurance company on the day of formation and deducted that amount on its 2007 return. Each year thereafter, the deducted consulting payments (legal, accounting, and management fees) were about $1.2 million. The micro-captive company did not include the $1.2 million in income. The Tax Court held that the arrangement did not qualify as insurance for tax purposes because the micro-captive company did not provide insurance (because there was no risk distribution). In addition, the Tax Court concluded that the arrangement did not resemble any type of commonly accepted notion of insurance. The Tax Court also upheld 20% accuracy related penalties for substantial understatement of tax and for negligence.

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161. On appeal, the U.S. Circuit Court of Appeals for the Tenth Circuit affirmed. *Reserve Mechanical Corp. v. Comm'r,* 34 F.4 th 122 (2022).

162. *Syzygy Insurance Co. v. Comm'r,* TC Memo 2019-34 (Apr. 10, 2019).

163. *Caylor Land & Development, Inc. v. Comm'r,* TC Memo 2021-30 (Mar. 10, 2021).

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Taxpayer Victory

In late 2021, the Tax Court entered an order in *Puglisi et al. v. Comm'r.*[164] The IRS conceded the case before trial to avoid an adverse ruling on the merits. The petitioners owned an egg farm in Delaware with more than 1.2 million egg-producing hens. The farm owned a liability insurance policy but was not able to buy insurance to insure against the Avian flu.

As a result, the petitioners formed a captive insurance company to provide additional coverage. The captive company was a Delaware corporation operating as a reinsurance company. The egg farm bought insurance from a fronting company. The fronting company then entered into a reinsurance arrangement with the captive company. Under the reinsurance arrangement, the captive insurance company reinsured 20% of all approved claims of the egg farm, and 80% of all approved claims of unrelated entities that the fronting company insured. The egg farm was organized as an LLC which resulted in deductions flowing through to the petitioners' personal returns. Before the IRS initiated an audit, the egg farm had submitted a total of five claims to the fronting company.

The IRS audited and issued statutory notices of deficiency (taxes and penalties) exceeding $2.7 million total for 2015, 2016, and 2018. Ultimately, the IRS conceded the deductions and sought an order from the Tax Court that the deficiency was a mere $18,587 for 2015. The petitioners objected, wanting the Tax Court to rule on whether the fronting company was an insurance company for income tax purposes because the issue of the deductibility of premiums paid to the fronting company would be an issue that would continue to arise annually and they wanted the issue resolved. In addition, many other businesses paid insurance premiums to the fronting company that were reinsured, at least in part, by the petitioner's captive insurance company. The Tax Court refused to rule on the matter and entered a decision in line with the IRS' concession. Presently, it remains to be seen whether the IRS will challenge the petitioners' captive insurance company in the future.

> **Note.** It is important to note that the IRS continued to maintain that the fronting company was not an insurance company for tax purposes, even though it conceded the tax deficiency issue.

Administrative Issues

2016 IRS Notice. In 2016, the IRS identified certain micro-captive transactions as having the potential for tax avoidance and evasion.[165] The IRS indicated that micro-captive insurance transactions that are the same as, or substantially similar to, the transactions described in IRS Notice 2016-66 would be considered "transactions of interest." Under the notice, these transactions require information reporting as "reportable transactions" under Treas. Reg. §1.6011 and IRC §§6011 and 6012 for taxpayers engaging in the transactions and their "material advisers." Thus, persons entering into micro-captive transactions were required to disclose such transactions to the IRS via Form 8886, *Reportable Transaction Disclosure Statement,* and material advisors also had disclosure and maintenance obligations under IRC §§6111 and 6112 and the associated regulations. In addition, a material advisor had to file a disclosure statement (Form 8918, *Material Advisor Disclosure Statement*) with the IRS Office of Tax Shelter Analysis by January 30, 2017, with respect to such transactions entered into on or after November 2, 2006. Failure to make the required disclosures came with possible civil and/or criminal penalties. On December 30, 2016, the IRS extended the disclosure deadline for micro-captive transactions to May 1, 2017.[166]

> **Note.** After the issuance of the notice, the IRS audits of micro-captive arrangements and litigation ramped up substantially.

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164. *Puglisi et al. v. Comm'r,* No. 13489 (Nov. 5, 2021).

165. IRS Notice 2016-66, 2016-47 IRB 745.

166. IRS Notice 2017-08, 2017-03 IRB 423.

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Challenge to Notice. A manager of captive insurance companies subject to the disclosure requirements challenged Notice 2016-66 in early 2017. The notice would have forced the manager to incur substantial compliance costs. The manager claimed that the notice constituted a legislative-type rule and, as such, was subject to the mandatory notice-and-comment requirements of the Administrative Procedure Act (APA).[167] The manager also claimed that the notice was invalid as being arbitrary and capricious, and that the IRS failed to submit the rule contained in the notice to Congress and the Comptroller General as required.[168] The manager sought a declaration under the Declaratory Judgment Act[169] that the notice was invalid and that an injunction barring the IRS from enforcing the disclosure requirements of the notice should be issued.

Note. Since 2019, the IRS has offered a settlement framework for taxpayers under audit on micro-captive insurance arrangements.[170] In 2020, the IRS made the settlement framework more restrictive and increased the number of examinations.[171] Under the 2020 framework, taxpayers are offered reduced accuracy-related penalties of 5%, 10% or 15% (instead of 20% or 40%). In exchange, a taxpayer must agree to have 90% of the premium deductions disallowed for all open tax years, as well as any captive-related expenses such as management fees. The captive insurance company must also be liquidated, or else there will be a deemed distribution to the owners for premiums paid to the captive during all years.

The trial court denied the plaintiffs' motion for a preliminary injunction, reasoning that the plaintiffs were not likely to succeed on the merits because the claims were likely barred by the Anti-Injunction Act (AIA).[172]

Note. The AIA provides that "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court." Instead, a tax can be challenged in court only after the plaintiff pays the disputed tax and files a claim for refund.

The IRS moved to dismiss the plaintiffs' claims. The trial court granted the motion and dismissed the case for lack of subject matter jurisdiction.[173] The appellate court affirmed.[174] On further review, however, the U.S. Supreme Court reversed, vacated the appellate court's decision, and remanded the case to the trial court.[175] The Court unanimously held that the AIA did not bar pre-enforcement judicial review of the notice. The Court pointed out that while the notice was backed by tax penalties, the plaintiffs' suit challenged the notice's "reporting mandate separate from any tax." On remand, the trial court set aside the notice and ordered the IRS to return all documents that it had collected under the notice. The trial court stated:[176]

> *While the IRS may ultimately be correct that micro-captive insurance arrangements have the potential for tax avoidance or evasion and should be classified as transactions of interest, the APA requires that the IRS examine relevant facts and data supporting that conclusion.*

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167. 5 USC §553, et seq.

168. 5 USC §801.

169. 28 USC §2201.

170. IRS News Rel. IR-2019-157 (Sep. 16, 2019).

171. IRS News Rel. IR-2020-26 (Jan. 31, 2021) and IRS News Rel. IR-2020-241 (Oct. 22, 2020).

172. 26 USC §7421.

173. *CIC Services, LLC v. IRS,* No. 3:17-cv-110, 2017 U.S. Dist. LEXIS 181482 (E.D. Tenn. Nov. 2, 2017).

174. *CIC Services, LLC v. IRS,* 925 F.3d 247 (6th Cir. 2019).

175. *CIC Services, LLC v. IRS,* 141 S. Ct. 1582 (2021).

176. *CIC Services, LLC v. IRS*, No. 3:17-cv-00110 (E.D. Tenn. Mar. 21, 2022).

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Shortly before the trial court's remand decision in *CIC Services, LLC,* the U.S. Court of Appeals for the Sixth Circuit voided IRS Notice 2007-83,[177] that established reporting requirements for potentially abusive benefit trust arrangements or face the imposition of civil and/or criminal penalties for engaging in such a listed transaction.[178] With Notice 2007-83, the appellate court concluded that the IRS had developed a legislative rule without going through the APA's required notice and comment procedures. Congress had not created any exemption for the IRS from this rulemaking requirement. Indeed, the appellate court pointed out in *Mann Construction, Inc.* that the U.S. Supreme Court had rejected the notion that tax law deserves a special carve-out from the APA's notice and comment requirement.[179]

> **Note.** Before getting pushed back by the courts for rulemaking without following the APA's rulemaking requirements, the IRS gave some indication that it was also looking at captive insurance company variations.[180]

Filing Obligations

In the summer of 2020, the IRS issued §6112 letters to persons it believed to be a material advisor who failed to report themselves for engaging in an abusive transaction. Because the courts have now voided Notice 2016-66, the filing of Form 8918 and the associated penalties are currently not in play. **But the IRC §6694 preparer penalties are still applicable for taking an unreasonable position on the return.** Also, the IRS could follow the APA's notice-and-comment procedures and properly adopt its position taken in Notice 2016-66 in the future. If the IRS does, it appears to have attorneys trained to review captive insurance company issues. Thus, tax practitioners would be well-advised to proceed with caution when engaging with clients interested in captive insurance and examine client files where captive insurance companies have already been established.

> **Caution.** Large farm operations that determine a captive insurance subsidiary may be financially advantageous should engage a professional firm that is familiar with these entities.

TAX ISSUES WITH CUSTOMER LOYALTY PROGRAMS

Many companies, including agribusiness retailers, utilize customer loyalty programs as a means of attracting and keeping customers. Under the typical program, each time a customer or member buys a product or service, the customer earns reward points. The reward points accumulate and are computed as a percentage of the customer's purchases. When accumulated points reach a designated threshold, they can then be used to buy an item from the retailer or can be used as a discount on a subsequent purchase (e.g., cents per gallon off of a fuel purchase). Some programs may be structured such that a reward card is given to the customer after purchases have reached the threshold amount. The reward card typically has no cash value and expires within a year of being issued. A loyalty rewards program is a cost to the retailer and a benefit to the customer, triggering tax issues for both.

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177. IRS Notice 2007-83, 2007-2 CB 960.

178. *Mann Construction, Inc. v. U.S.,* No. 21-1500, 2022 U.S. App. LEXIS 5668 (6th Cir. Mar. 3, 2022), *rev'g.,* 539 F.Supp. 3d 745 (E.D. Mich. 2021).

179. *Mayo Foundation for Medial Education & Research v. U.S.,* 562 U.S. 44 (2011).

180. See IRS News Rel. IR-2020-226 (Oct. 1, 2020); IRS Field Attorney Advice FAA 20211701F (Feb. 5, 2021).

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TREASURY REGULATIONS — IMPACT ON RETAILERS

Treas. Reg. §1.461-4(g)(3) addresses the treatment of rebates and refunds and specifies that economic performance occurs when payment is made to the person to whom the liability is owed. The IRS position is that a retailer cannot claim a deduction until the points are actually redeemed because the event fixing the retailer's liability occurs when a member reaches the minimum number of points for redemption **and** actually redeems the points.[181] But, for an accrual basis taxpayer, the taxpayer's liability becomes fixed (and, hence, a deduction can be claimed) when the customers earn the rewards.[182] A deduction is not deferred until the customer redeems the rewards.

> **Note.** The IRS does not agree on this point and only follows the Third Circuit's decision in cases appealable to the Third Circuit that cannot be distinguished.[183]

Treas. Reg. §1.451-4 addresses trading stamps and premium coupons that are issued with sales and are redeemable in cash, merchandise, or **other property.** These are the two basic requirements of the regulation, and most retailer customer loyalty programs satisfy both tests. The IRS, in a matter involving an accrual basis supermarket chain that had a rewards program that allowed customers to get a certain amount of gas for free depending on purchases of products, said that the supermarket could take a current deduction for the value of the gas rewards.[184] The IRS reached that result by concluding that the gas rewards were being redeemed for other property.[185]

Loyalty reward programs that might not satisfy the "redeemable in cash, merchandise or other property test" might be programs that provide customers with cents-off coupons. With these programs, the IRS could argue that a customer's right to redeem the coupon is conditioned on a future purchase and, as a result, the coupon liability should be matched to the later sale when the liability becomes fixed and determinable and economic performance occurs.[186]

The regulation provides that the estimated redemption costs of premium coupons issued in connection with the sale of merchandise is deductible **in the year of the merchandise sale,** even though the reserves for future estimated redemption costs (1) are not fixed and determinable, and (2) do not otherwise meet the economic performance rules of the all-events test.[187]

Loyalty programs that satisfy the two tests of Treas. Reg. §1.451-4 may find this method preferential from a tax standpoint. For retailers that can qualify but are not presently using the Treas. Reg. §1.451-4 approach, a method change is required.[188] If a loyalty program does not meet the requirements to use Treas. Reg. §451-4, the redemption liability is treated as a deduction and not as an exclusion from income. Thus, the redemption liability is considered in the tax year in which the liability becomes fixed and determinable and economic performance occurs under IRC §461. That will, in general, be the year in which the customer redeems the loyalty rewards.

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181. Ltr. Rul. 200849015 (Dec. 5, 2008).
182. *Giant Eagle, Inc. v. Comm'r,* 822 F.3d 666 (3d Cir. 2016), *rev'g.,* TC Memo 2014-146.
183. AOD 2016-03 (Oct. 3, 2016).
184. FSA 20180101F (Nov. 7, 2017).
185. Treas. Reg. §1,451-4(a)(1).
186. IRC §461.
187. Treas. Reg. §1.451-4.
188. The method change is achieved by using the advance consent procedures of Rev. Proc. 97-27, 1997-1 CB 680.

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TAX ISSUES FOR CUSTOMERS

> **Observation.** Cash rebates or rewards program benefits paid in cash by input suppliers to customers are taxable income even if no Form 1099 is provided.

A recent Tax Court opinion provides guidance on how a taxpayer, as a user of a rewards program, is to report the transactions on their return, and whether the IRS "rebate rule" is applicable. In *Anikeev, et ux. v. Comm'r,*[189] the petitioners, a husband and wife, spent over $6 million on their credit card between 2013 and 2014. Nearly all these purchases were for Visa gift cards, money orders, or prepaid debit card reloads that the couple later used to pay the credit card bill. The credit card earned them 5% cash back on certain purchases after they spent $6,500 in a single calendar year. Before purchases were sufficient for them to reach the 5% level, the card earned 1% cash back on certain purchases.

Rewards were issued in the form of rewards dollars that could be redeemed for gift cards and statement credits. In 2013, the petitioners redeemed $36,200 in rewards dollars from the card as statement credits in 2013 and $277,275 in 2014. The petitioners did not report these amounts as income for either year. The IRS audited and took the position that the earnings should have been reported as "other income" as an exception to the IRS "rebate rule." Under the rule, when a seller makes a payment to a customer, it is generally seen as a "price adjustment to the basis of the property." It is a purchase incentive that is **not** treated as income. Instead, the incentive is treated as a **reduction of the purchase price** of what is purchased with the rewards or points. Thus, points and cashback earned on spending are viewed as a nontaxable purchase price adjustment. The petitioners cited this rule, pointing out that the "manner of purchase of something … does not constitute an accession of wealth." The IRS, however, claimed that the rewards were taxable upon receipt irrespective of how the gift cards were later used.

The Tax Court noted that the gift cards were a **product.** Thus, the portion of their reward dollars associated with gift card purchases were not taxable. However, the Tax Court held that the petitioners' direct purchases of money orders and reloads of cash into the debit cards using their credit card was different in that the petitioners were buying cash equivalents rather than a rebate on a purchase. Thus, the transaction did not involve the purchase of a product subject to a price adjustment. The purchase of a cash equivalent was different than obtaining a product or service. Because there was no product or service obtained in connection with **direct** money order purchases and cash reloads, the reward dollars associated with those purchases were for taxable cash infusions.

The Tax Court also noted that the petitioners' practice would most often have been ignored if it had not been for the petitioners' manipulation of the rewards program using cash equivalents. Thus, the longstanding IRS rule of not taxing credit card points did not apply. Importantly, the Tax Court held that reward points become taxable when massive amounts of cash equivalents are purchased to generate wealth. The petitioners did this by buying money orders and funding prepaid debit cards with a credit card for cash back, and then immediately paying the credit card bill.

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[189]. *Anikeev, et ux. v. Comm'r,* TC Memo 2021-23 (Feb. 23, 2021).

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