Chapter 11: Agricultural Issues and Rural Investments

Note. Corrections were made to this workbook through January of 2025. No subsequent modifications were made. For clarification about terms used throughout 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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FINANCIAL DISTRESS-RELATED ISSUES

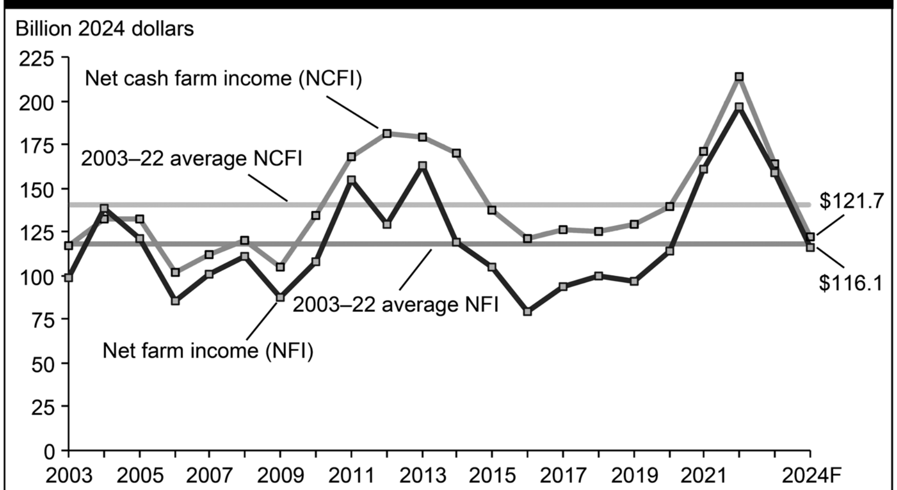
GENERAL ECONOMIC CONDITIONS[1]

According to the U.S. Department of Agriculture (USDA), farm sector income is forecasted to continue to fall in 2024 after reaching record highs in 2022. Net farm income reached $185.5 billion (in nominal dollars) in calendar year 2022. After decreasing by $29.7 billion (16.0%) from 2022 to an estimated $155.9 billion in 2023, net farm income in 2024 is forecasted to decrease further from the 2023 level by $39.8 billion (25.5%) to $116.1 billion.

In inflation-adjusted 2024 dollars, net farm income is forecasted to decrease by $43.1 billion (27.1%) from 2023 to 2024, and net cash farm income is forecasted to decrease by $42.2 billion (25.8%) compared with the previous year. If realized, both measures in 2024 would fall below their 2003-2022 averages (in inflation-adjusted dollars).

The following graph from the USDA shows the inflation-adjusted net farm income (NFI) and net cash farm income (NCFI).

U.S. net farm income and net cash farm income, inflation adjusted, 2003–24F



Note: F = forecast; data for 2023 and 2024 are forecasts. Values are adjusted for inflation using the U.S. Department of Commerce, Bureau of Economic Analysis, Gross Domestic Product Price Index (BEA API series code: A191RG) rebased to 2024 by USDA, Economic Research Service.
Source: USDA, Economic Research Service, Farm Income and Wealth Statistics.
Data as of February 7, 2024.

Economic stress in agriculture can appear in numerous ways. Two of those that involve unique tax issues are losses on interests in cooperatives (co-ops) and repossessions (both voluntary and involuntary).

GENERAL RULES ON COOPERATIVE LOSS DEDUCTIBILITY

When the farm economy faces a downturn, it is often characterized by lower commodity prices. When lower commodity prices are coupled with higher input costs, many farming operations may generate losses. The same result can also occur for co-ops and businesses that provide production inputs. Co-ops are particularly vulnerable to an economic downturn in the agricultural economy because they tend to be highly leveraged.

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1. *2024 Farm Sector Income Forecast.* Feb. 7, 2024. U.S. Department of Agriculture. [www.ers.usda.gov/topics/farm-economy/farm-sector-income-finances/farm-sector-income-forecast] Accessed on Jul. 2, 2024.

Any resulting losses are governed by tax rules that are highly unique. For instance, a membership interest in a co-op may provide the owner with both an ordinary loss and a capital loss. No other organization structure allows this tax treatment for losses.

For a co-op interest that represents a retained patronage dividend held by a co-op, or redemption of qualified written notices of allocation at less than the stated amount on issuance, the holder of the interest may claim an ordinary loss for that portion of the total loss.[2] The facts of the applicable Revenue Ruling involved a chicken farmer who acquired supplies from a local co-op.[3] The IRS reasoned that the amount of the loss in question had already been subjected to income tax. Thus, **ordinary** loss treatment was appropriate. However, if allocated patronage dividends are not involved, and the transaction only involves the taxpayer's investment in co-op stock, gains and losses are **capital.**[4]

Note. If a co-op's losses involve an asset,[5] the losses are not eligible for IRC §1231 treatment because such treatment is limited to "property used in a trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than one year, and real property used in the trade or business, held for more than one year…." That definition does not include an equity interest held in a co-op.

Timing Issue

Whether a loss attributable to a co-op membership interest is deductible depends on whether the loss is treated as associated with a worthless security[6] or a bad debt.[7]

Worthless Security. There is no guidance in either the Code or the Treasury Regulations on whether co-op stock losses are treated as a worthless security. However, the Board of Tax Appeals, the predecessor of the Tax Court, has applied the worthless security rules to co-op losses.[8] The IRS issued a non-acquiescence to the Board's opinion, but the Seventh Circuit affirmed on appeal.[9] For co-op stock treated as a worthless security, a deduction may be claimed up to cost (or other basis) **in the year the stock becomes totally worthless.**[10] No deduction is allowed for partially worthless stock.

Note. Because of the requirement to be totally worthless, any losses a co-op sustains in a Chapter 11 (reorganization) bankruptcy are not deductible until there is a formal determination that the securities are worthless.[11] In addition, the IRS has taken the position that abandonment is not an indispensable requirement to establish worthlessness.[12] It is merely one of several factors.[13]

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2. Rev. Rul. 70-64, 1970-1 CB 36.
3. Ibid.
4. IRC §§1211 and 1221. This would be the result, for example, for investors in a co-op that files bankruptcy who were not otherwise involved in the co-op's business activities.
5. For IRC §1231 assets, gains may be capital gains, but losses are ordinary losses.
6. IRC §165(g).
7. IRC §166(a).
8. *Morton v. Comm'r*, 38 BTA 1270 (1938), *nonacq.* 1939-1 CB 57, *aff'd* 112 F.2d 320 (7th Cir. 1940). The case involved a co-op apartment building that was formed as a syndicate.
9. Ibid.
10. IRC §165(g); Treas. Reg. §1.165-5(c). See also *Wagner v. U.S.*, No.: 6:01-cv-1218-Orl-18JGG (M.D. Fla. Jan. 21, 2003) and *Geddis v. Comm'r*, TC Memo 2005-191 (Aug. 4, 2005).
11. To be totally worthless, a loss must be evidenced by closed and completed transactions that are fixed by identifiable events and sustained during the taxable year. Treas. Reg. §§1.165-1 (b) and (d).
12. CCA 200851050 (Oct. 27, 2008).
13. Ibid.

If the co-op stock is a capital asset, it is subject to the limitation on capital losses.[14] Otherwise, a security that becomes wholly worthless during the tax year gives rise to an ordinary loss.[15] Thus, stock in a co-op that was merely acquired as an investment and does not involve patronage is classified as a capital asset that would be subjected to treatment as a worthless security.[16] If the interest involves patronage in the co-op, treatment as a worthless security would arguably depend on whether the interest meets the definition of a "security."[17]

> **Note.** In Rev. Rul. 70-64,[18] the IRS allowed ordinary loss treatment on a co-op interest that represented retained patronage because the interest was not considered to be a capital asset. However, Rev. Rul. 70-64 was issued before the 1988 case of *Arkansas Best Corp. v. Comm'r,*[19] where the U.S. Supreme Court pointed out that everything is considered a capital asset unless a specific exclusion from the definition applies.

Bad Debt Deduction. If a co-op interest does not meet the definition of a worthless security on the basis that a co-op interest representing retained patronage is not a "security," any loss on the interest might be deductible as a bad debt.[20] A bad debt is deductible in the year the debt becomes worthless.[21] To be deductible, a bad debt need not be totally worthless — a deduction is allowed up to the amount "charged off" within the tax year.[22] That is the rule for a **business bad debt** — a debt incurred in the conduct of the taxpayer's trade or business. The rule is different for a nonbusiness bad debt. For a **nonbusiness bad debt,** the debt is not deductible until the year in which it becomes totally worthless.[23] A nonbusiness bad debt is incurred other than from the conduct of the taxpayer's trade or business.[24]

REPOSSESSION OF PROPERTY SOLD UNDER AN INSTALLMENT SALE

> **Note.** Installment sales are discussed in detail later in this chapter. Additionally, for more information on installment sales, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 6: Installment Sales.

Repossession of Land

A special exception exists under IRC §1038 that is favorable to sellers repossessing land under an installment sale. The gain on repossession of real property must be calculated and reported per §1038 if the transaction comes within the statute. In applying the rules, it is immaterial whether the seller realized a gain or sustained a loss on the sale of the real property or whether it can be ascertained at the time of sale whether a gain or loss occurred. It is also immaterial what method of accounting the seller used in reporting gain or loss from the sale or whether at the time of reacquisition the property has increased or decreased in value since the time of the original sale.

The rules **do not** apply if the disposition constitutes a tax-free exchange of the property. In addition, for the special rules to apply, the debt must be secured by the real property. Amounts of interest income received, stated or unstated, are excluded from the computation of gain.

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14. Treas. Reg. §1.165-5(c).
15. Treas. Reg. §1.165-5(b).
16. Treas. Reg. §1.165-5(c).
17. IRC §1221(a).
18. Rev. Rul. 70-64, 1970-1 CB 36.
19. *Arkansas Best Corp. v. Comm'r*, 485 U.S. 212 (1988).
20. IRC §§166(a) and (e). The bad debt and worthless security provisions are mutually exclusive.
21. IRC §166(a)(1).
22. IRC §166(a)(2). A formal declaration of a bankruptcy court declaring that a debt has been "charged off" would meet the test.
23. Treas. Reg. §1.166-5(a). See also *Scagliotta v. Comm'r*, TC Memo 1996-498 (Nov. 6, 1996) and *Powerstein v. Comm'r*, TC Memo 2011-271 (Nov. 16, 2011).
24. IRC §166(a)(2).

Calculating Gain on Repossession of Real Property

On repossession, whether voluntary or involuntary, the amount of gain recognized is the lesser of the following.

1. The amount of cash and the fair market value (FMV) of other property received before the reacquisition (but only to the extent such money and other property exceeds the amount of gain reported before the reacquisition); or
2. The amount of gain realized on the original sale (adjusted sales price less adjusted income tax basis) in excess of the gain previously recognized before the reacquisition and the money or other property transferred by the seller in connection with the reacquisition.[25]

Because the provision is applicable only when the seller reacquires the property to satisfy the purchaser's debt, it is generally inapplicable where the seller repurchases the property by paying the buyer an extra sum in addition to canceling the debt. The rules generally are applicable, however, if the seller reacquires the property when the purchaser has defaulted or when default is imminent, even if the seller pays additional amounts. The provisions on repossession of real property do not apply except where the indebtedness was secured by the real property. Therefore, reconveyance of property by the obligor under a private annuity to the annuitant would appear not to come within the rules.[26]

Example 1. On December 31, 2022, Burt DuLapp sold farmland to Ernie Pyle for $150,000 on an installment basis. Burt originally acquired the land in 1985. The contract called for $15,000 down and payments of $15,000 per year for nine years. Burt's adjusted income tax basis in the property at the time of sale was $30,000.

Burt received the down payment and the first regular payment for the following year ($30,000 total), with all payments reported as income. Burt's gross profit is $120,000 ($150,000 contract price – $30,000 basis) and his gross profit percentage is 80% ($120,000 gross profit ÷ $150,000 contract price). By the end of 2023, Burt had reported $24,000 of the gain as income ($30,000 total payments × 80% gross profit percentage).

In 2024, Burt proceeds to repossess Ernie's interest in the property due to Ernie's request to be removed from the contract.

Burt completes the following Worksheet D from IRS Pub. 537, *Installment Sales,* to calculate the $6,000 gain on repossession.

Worksheet D. **Taxable Gain on Repossession of Real Property** *Keep for Your Records*

Note. Use this worksheet to determine taxable gain on the repossession of real property if you used the installment method to report the gain on the original sale.

1.	Enter the total of all payments received or treated as received before repossession	**30,000**
2.	Enter the total gain already reported as income	**24,000**
3.	Subtract line 2 from line 1. This is your gain on the repossession	**6,000**
4.	Enter your gross profit on the original sale	**120,000**
5.	Enter your costs of repossessing the property	**0**
6.	Add line 2 and line 5	**24,000**
7.	Subtract line 6 from line 4	**96,000**
8.	Enter the lesser of line 3 or line 7. This is your taxable gain on the repossession	**6,000**

25. IRS Pub. 537, *Installment Sales*.

26. Treas. Reg. §1.1038-1(a)(2)(i).

Note. If an installment sale involves a personal residence along with farmland, complications can arise if the seller reacquires the property and had excluded the gain attributable to the personal residence under IRC §121. Unless the personal residence is re-sold within a year of the reacquisition, the gain excluded under §121 is, essentially, recaptured in accordance with §1038.[27]

The character of the gain from reacquisition is determined by the character of the gain from the original sale.[28] For an original sale reported on the installment method, the character of the reacquisition gain is determined as though there had been a disposition of the installment obligation. If the sale was reported on the **deferred payment method,** and there was voluntary repossession of the property, the seller reports the gain as ordinary income.[29] If the debts satisfied were securities issued by a corporation, government, or political subdivision, the gain would be capital gain.[30]

Once the seller has reacquired the property, it is important to determine the seller's basis in the reacquired property. The adjusted income tax basis for the property in the hands of the reacquiring seller is the sum of the following three amounts.[31]

1. The adjusted tax basis to the seller of the indebtedness, determined as of the date of reacquisition;
2. The taxable gain resulting from reacquisition; and
3. The money and other property (at FMV) paid by the seller as reacquisition costs.

Example 2. Use the same facts as **Example 1.** Assuming Burt did not pay any reacquisition costs, his basis in the reacquired property is $30,000. His adjusted tax basis prior to the sale was $30,000 less $6,000 basis applied to the first two years of payments, plus $6,000 of taxable gain resulting from reacquisition.

Note. The holding period of the reacquired property, for purposes of subsequent disposition, includes the holding period during which the seller held the property before the original sale plus the period after reacquisition.[32] However, the holding period does not include the time between the original sale and the date of reacquisition.

The provisions on reacquisition of property generally apply to residences or the residence part of the transaction. However, the repossession rules do not apply if:[33]

1. An election is in effect for an exclusion of gain on the residence, and
2. The property is resold within one year after the date of reacquisition.

If those conditions are met, the resale is essentially disregarded and is considered to constitute a sale of the property as of the original sale. In general, the resale is treated as occurring on the date of the original sale. An adjustment is made to the sales price of the old residence and the basis of the new residence. If not resold within one year, gain is recognized under the rules for repossession of real property. An exclusion election is considered in effect if an election has been made and not revoked as of the last day for making such an election. The exclusion can, therefore, be made after reacquisition. An election can be made at any time within three years after the due date of the return.

27. See, e.g., *Debough v. Comm'r*, 142 TC 17 (2014).

28. IRS Pub. 537, *Installment Sales*.

29. Ibid.

30. Ibid.

31. IRC §§1038(b) and (c).

32. Ibid.

33. IRC §1038(e).

A bad debt deduction is not permitted for a worthless or a partially worthless debt secured by a reacquired personal residence. The tax basis of any debt not discharged by repossession is zero.[34]

Losses are not deductible on the sale or repossession of a personal residence.[35] When gain is not deferred or excluded, the repossession of a personal residence is treated under the general rule as a repossession of real property. An adjustment is made to the tax basis of the reacquired residence.

In 1969, the IRS ruled that the special provisions on the income tax treatment of the reacquisition of property did not apply to reacquisition by the estate of a deceased taxpayer.[36] A decedent's estate was not permitted to succeed to the income treatment that would have been accorded a reacquisition by the decedent. The Installment Sales Revision Act of 1980[37] changed that result. The provision is effective for "acquisitions of real property by the taxpayer" after October 19, 1980. Presumably, that means acquisitions by the estate or beneficiary. Under the 1980 amendments, the estate or beneficiary of a deceased seller is entitled to the same nonrecognition treatment upon the acquisition of real property in partial or full satisfaction of secured purchase money debt as would have the deceased seller. The tax basis of the property acquired is the same as if the original seller had reacquired the property, except that the basis is increased by the amount of the deduction for federal estate tax which would have been allowable had the repossession been taxable.

The IRS ruled in 1986 that the nonrecognition provision on repossessions of land does not apply to a former shareholder of a corporation who receives an installment obligation from the corporation in a liquidation when that shareholder, upon default by the buyer, subsequently receives the real property used to secure the obligation.[38]

Repossession of Personal Property Under Installment Sale[39]

The tax consequences of repossession of **personal** property originally sold under an installment sale are more painful to the seller when compared to the rules applicable to repossession of **real** property. In these situations, the relief provisions of §1038 do not apply. Upon repossession, the seller realizes gain or loss in the year of repossession, the same as if the note or other obligation had been sold.

Voluntary Repossessions. Voluntary repossessions are those where the purchaser, upon being unable to make payment, voluntarily agrees to return the property to the seller in full satisfaction of the outstanding debt. The gain or loss is determined by the difference between the FMV of the repossessed personal property determined as of the date of repossession and the seller's tax basis in the purchaser's note or other obligation that is satisfied by the repossession.[40] The seller's basis in the obligation is the face value of the purchaser's note determined as the contract price less the principal payments made under the contract minus the unrealized profit, which is the percentage of profit times the unpaid principal balance.[41] The seller must adjust this basis figure for any other amounts collected or costs incurred in repossession.[42]

34. IRC §1038(c)(2).

35. IRS Pub. 523, *Selling Your Home*, Worksheet 2.

36. Rev. Rul. 69-83, 1969-1 CB 202.

37. *Installment Sales Revision Act of 1980,* PL 96-471.

38. Rev. Rul. 86-120, 1986-2 CB 145.

39. IRC §§483 and 1274.

40. IRS Pub. 537, *Installment Sales*.

41. Ibid.

42. Ibid., See Worksheet C.

Example 3. Bob Upp sold a tractor for $30,000 on an installment basis. Bob's tax basis in the tractor at the time of sale was $18,000. The gain of $12,000 was calculated with a 40% gross profit percentage. The buyer defaulted when the outstanding balance was $20,000 and the FMV of the tractor was $16,000.

Gain on an installment sale must be reported as income in the year of sale to the extent there is depreciation recapture. However, Bob claimed no depreciation on the tractor because it was not used in a trade or business. Bob offered to cancel the outstanding obligation if the buyer would return the tractor. The buyer agreed to return the tractor. The amount of gain that Bob must recognize upon repossession is calculated as follows.

FMV of property when repossessed		$16,000
Less: seller's basis in obligation given up:		
Original contract price	$30,000	
Less: payments received	(10,000)	
Balance of contract price	$20,000	
Less: unrealized profit ($20,000 × 40%)	(8,000)	
Nontaxable return of basis	$12,000	(12,000)
Gain on repossession		$ 4,000
Less: repossession costs		(1,200)
Recognized gain		$ 2,800

The character of the gain or loss is the same as on the original sale. If the obligation arose from a sale by a dealer to a customer, gain or loss on repossession is ordinary income, and the amount can be shown (on the dealer's income tax return and in the dealer's books) as an adjustment to the cost of goods sold. For a gain, purchase costs would be decreased. For a loss, purchase costs would be increased. If the original property was §1231 property (property used in the trade or business), it would be shown on Form 4797, *Sales of Business Property,* with a separate sheet showing the computation of the gain or loss. **If the original sale involved a capital asset and it was nonbusiness property,** it would be shown on Form 8949, *Sales and Other Dispositions of Capital Accounts,* flowing through to Schedule D, *Capital Gains or Losses,* with a separate sheet showing the computation of the gain or loss.[43]

Involuntary Repossessions. An involuntary repossession or foreclosure occurs when the purchaser is in default and is unwilling to return the property to the seller. The foreclosure sale or other action by the seller may involve bidding by the original seller or by a third party to reacquire the property. The original seller may buy back the property, or a third party may purchase the property and turn over the proceeds to the seller. If the original seller regains the property, it is assumed the seller paid the current FMV for the property. In either case, the FMV of the property at the time of sale may not be sufficient to cover the outstanding debt. In that event, the seller may obtain a deficiency judgment against the original purchaser for the remaining debt. If the seller receives only a partial payment of the debt, then the original purchaser remains liable for the balance as evidenced in the deficiency judgment.

The gain or loss is computed using the same procedure as in a voluntary repossession.

43. IRS Pub. 537, *Installment Sales*.

Example 4. Use the same facts as **Example 3,** except that the property was not returned voluntarily. Bob took action under allowed legal remedies, and sold the property at a foreclosure sale. A third party purchased the property for $16,000 with the proceeds turned over to Bob in partial satisfaction of the $20,000 debt outstanding at the time of the obligation. Bob obtained a deficiency judgment for $4,000 in his favor for the remaining amount of the obligation.

The gain on the repossession is calculated as follows.

FMV upon repossession		$16,000
Less: seller's basis in obligation given up:		
Original contract price	$30,000	
Less: payments received	(10,000)	
Balance of contract price	$20,000	
Less: deficiency judgment	(4,000)	
Balance of installment note unpaid	$16,000	
Less: unrealized profit ($16,000 × 40%)	(6,400)	
Nontaxable return of basis	$ 9,600	(9,600)
Less: repossession costs		(1,200)
Recognized gain		$ 5,200

Bob receives $16,000 in cash. The tax basis of the amount received is $9,600 (60% of the $16,000 face value). The gain of $6,400 is adjusted downward by the costs of repossession which totaled $1,200. The result is $5,200 of recognized gain.

Note. When comparing the involuntary repossession situation with the voluntary repossession situation, the involuntary repossession produces a recognized gain of $5,200, whereas in the voluntary repossession, recognized gain is $2,800. The seller cancels the entire outstanding debt of $20,000 in the voluntary repossession but only cancels $16,000 of the outstanding debt in the involuntary repossession scenario. The buyer remains liable for the $4,000 balance of the outstanding obligation because of the deficiency judgment. If and when the entire deficiency judgment amount of $4,000 is paid, Bob, the seller, must report $1,600 of gain. Of the $4,000 received, 60%, or $2,400, is a tax-free return of basis and is deductible as a bad debt deduction when worthless.

The tax basis of the reacquired property in the hands of the seller for purposes of a subsequent disposition (or for depreciation) would be the FMV of the property at the time of the involuntary repossession adjusted for the interim period. The tax basis is the same whether repossession is voluntary or involuntary.

When an involuntary repossession occurs, a bad debt deduction is allowable if the outstanding debt is greater than the FMV of the item repossessed by the seller. The timing and nature of the bad debt deduction depend upon whether the excess debt over the FMV of the item received is uncollectible and whether the seller is a dealer in personal property. If the seller is not a dealer in personal property, a bad debt deduction is allowed in the year the remaining debt becomes completely worthless. A bad debt deduction is allowed to a dealer only if the property is not repossessed.[44]

Example 5. Use the same facts as **Example 4.** If the entire $4,000 is determined to be uncollectible, the $2,400 of Bob's basis in the obligation (60% × $4,000) would be allowable as a bad debt deduction. The bad debt deduction is the difference between the gain reported in the voluntary repossession scenarios ($2,800) and the gain reported in the involuntary scenario ($5,200). Thus, the final income tax consequences should be the same for voluntary and involuntary repossession if equal amounts of debt are discharged.

44. Ibid.

LLCs AND SELF-EMPLOYMENT TAX

Farmers and ranchers often desire to manage self-employment (SE) tax. One way to structure a business to minimize SE tax might be as a limited liability company (LLC). For an LLC member that truly has a limited partnership interest, SE tax savings can be achieved. But truly being a limited partner is the key. The definition of a "limited partner" as an LLC member for SE tax purposes has been unclear and confusing for some time.

> **Note**. Farming operations that participate in the federal farm programs and are large enough to qualify for more than a single payment limit (currently $125,000 per person)[45] should have the operating entity structured as either a general partnership or joint venture under the current program payment limitation rules to be eligible for more than a single payment limit. The ownership interests in the operating entity can be owned in an LLC to potentially minimize SE tax and, perhaps, net investment income tax (NIIT).

NET EARNINGS FROM SELF-EMPLOYMENT

Net earnings from self-employment include the distributive share of income or loss from a trade or business carried on by a partnership.[46] Thus, the default rule is that all partnership income is included unless it is specifically excepted. However, under IRC §1402(a)(13), a limited partner does not have SE income except for any guaranteed payments paid for services rendered to the LLC. IRC §1402(a)(13) states the following.

> *there shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.*

The test of whether an ownership interest in an entity treated as a partnership for tax purposes is treated as a limited interest or a general interest, for the purpose of applying the SE tax, is stated at Prop. Treas. Reg. §1.1402(a)-2(h), issued in 1997.

> **Note.** Immediately after the Prop. Treas. Reg. was issued, Congress passed a statute prohibiting the IRS from finalizing the Reg. within one year. Nothing further has been forthcoming. Although still in proposed form, this regulation remains the best available authority.

The Prop. Treas. Reg. establishes a 3-part general rule, with two exceptions, that may permit limited partner treatment under certain conditions.

> **Note.** A third exception to limited partner treatment applies in the context of professional service businesses (e.g., law, accounting, health, engineering, etc.).[47] Such partners cannot be a limited partner under Prop. Treas. Reg. §1.1402(a)-2(h)(4) (or (2) or (3)).[48] Thus, for a professional services partnership, structuring as a manager-managed LLC would have no beneficial impact on SE tax liability. However, if a member of a services partnership (e.g., LLC) is merely an investor that is not involved in the operations of the LLC as a business **and is separately paid for services rendered,** any distributive share is not subject to SE tax.[49] However, if the distributive share is received from fees from the LLC's business, the distributive share is subject to SE tax.[50]

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45. This is the general payment limit. See *FSA Handbook: Payment Limitation, Payment Eligibility, and Average Adjusted Gross Income — 6-PL*. Jul. 12, 2023. FSA. [www.fsa.usda.gov/Internet/FSA_File/6-pl_r00_a03.pdf] Accessed on Jul. 16, 2024.

46. IRC §1402(a).

47. Prop. Treas. Reg. §1.1402(a)-2(h)(5).

48. Ibid.

49. See, e.g., *Hardy v. Comm'r*, TC Memo 2017-16 (Jan. 17, 2017).

50. See, e.g., *Renkemeyer, Campbell, & Weaver, LLP v. Comm'r*, 136 TC 137 (2011).

Under the general rule, a member is **not** treated as a limited partner if they:

1. Have personal liability for the debts or claims against the LLC by reason of being a member;
2. Have authority under the state's LLC statute to enter into contracts on behalf of the LLC; or
3. Participated in the LLC's trade or business for more than 500 hours during the LLC's tax year.[51]

An exception applies only if the interest-holder owns a **single class of interest** regardless of whether there are multiple classes outstanding and failure of the 500-hour test is the sole reason for treatment of the interest as a general interest. In addition, the interest held must meet certain threshold requirements.

- There must be at least one member holding the same class of interest who meets all three of the requirements under the general rule, without application of any exceptions.
- The share of that class of interest held by those members must be "substantial" (with respect to the class of interest at issue and not with respect to the entity as a whole), based on the facts and circumstances (a safe harbor of 2%, in aggregate, is provided at Treas. Reg. §1.1402(a)-2(h)(6)(v)).
- The interests held by those members must be "continuing" (an undefined term).

Another exception to the general rule applies **only if the member owns at least two classes of interests** and the same threshold requirements are satisfied. This exception may permit a member to treat the distributive share attributable to at least one class as a limited interest if the three requirements of the general rule are met with respect to **any class** that the member holds. In that case, the distributive share attributable to that interest is not subject to SE tax. But the distributive share attributable to any interest held by a member that does not meet the three requirements of the general rule is subject to SE tax. Consequently, a portion of a member's total distributive share may be subject to SE tax, and some portion may not be subject.

> **Note.** Under the general rule, it is likely that the entire distributive share of all members of a **member-managed** LLC will be subject to SE tax because state law likely gives all members the authority to contract. Likewise, limited liability partnership (LLP) statutes likely give management rights where the second requirement of the general rule cannot be satisfied. As a result, neither exception to the general rule can be met because both exceptions require at least one member to satisfy all three requirements of the general rule.

Thus, an LLC can be structured as a **manager-managed** LLC with two membership classes. With that approach, the income of a member holding a manager's interest is subject to SE tax, but if non-managers who participate less than 500 hours in the LLC's business hold at least 20% of the LLC interests, then any non-manager interests held by members that participate **more** than 500 hours in the LLC's business are **not** subject to SE tax on the pass-through income attributable to their LLC interest.[52] Such members, however, are subject to SE tax on any guaranteed payments.

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For LLCs that are not a service partnership, such as a farming operation, it is possible to structure the business as a manager-managed LLC with a member holding both manager and non-manager interests that can be bifurcated. This results in a member holding both manager and non-manager interests that is not subject to SE tax on the pass-through income attributable to the non-manager interest, but is subject to SE tax on the pass-through income and a guaranteed payment attributable to the manager interest.

> **Note**. The Treasury has included guidance under §1402(a)(13) in its 2023-2024 Priority Guidance Plan.[53]

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51. Prop. Treas. Reg. §1.1402(a)-2(h)(2).

52. Prop. Treas. Reg. §1.1402(a)-2(h)(4).

53. *2023–2024 Priority guidance plan,* p.6. Sep. 29, 2023. IRS. [www.irs.gov/pub/irs-counsel/2023-2024-priority-guidance-plan-initial-version.pdf] Accessed on Jul. 2, 2024.

Example 6. A married couple operates a farming business as an LLC. The wife works full-time off the farm and does not participate in the farming operation. She holds a 49% non-manager ownership interest in the LLC. The husband conducts the farming operation full-time and also holds a 49% non-manager interest. He also holds a 2% manager interest. He receives a guaranteed payment for his manager's interest that equates to reasonable compensation for his services (labor and management) provided to the LLC. The result is that the LLC's income will be shared pro-rata according to the ownership percentages with the income attributable to the non-manager interests (98%) not subject to SE tax. The 2% manager interest is subject to SE tax along with the guaranteed payment that the husband receives. This produces a better SE tax result than if the farming operation were structured as a member-managed LLC.

MINIMIZATION OF NIIT

There is another potential benefit of utilizing the manager-managed LLC structure. The NIIT of IRC §1411 applies to a taxpayer's passive sources of income when adjusted gross income exceeds $250,000 on a joint return ($200,000 for a single return and $125,000 if married filing separately). While a non-manager's interest in a manager-managed LLC is typically considered passive with the income from the interest potentially subject to the 3.8% surtax, a spouse can take into account the material participation of a spouse who is the manager.[54] Thus, the material participation of the manager-spouse converts the passive income attributable to the non-manager spouse to active income that will not be subject to the 3.8% surtax.

> **Note.** Returning to **Example 6,** the manager-managed LLC structure significantly reduces SE tax (it is limited to the SE tax rate of 15.3% of the husband's reasonable compensation paid in the form of a guaranteed payment and his 2% manager interest), and the NIIT is avoided on the income of both spouses.

RECENT CASES

In *Castigliola, et al. v. Comm'r,*[55] a group of lawyers structured their law practice as a member-managed professional LLC (PLLC). On the advice of a CPA, they tied each of their guaranteed payments to what reasonable compensation would be for a comparable attorney in their locale with similar experience. They paid SE tax on those amounts. However, the Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.,* showed allocable income exceeding the member's guaranteed payment. They did not pay SE tax on the excess amounts. The IRS disagreed, assessing SE tax on all allocated amounts.

The Tax Court agreed with the IRS. Based on the Uniform Limited Partnership Act of 1916, the Revised Limited Partnership Act of 1976, and Mississippi law (the state in which the PLLC operated), the court determined that a limited partner is defined by limited liability and the inability to control the business. The members could not satisfy the second test. Because of the member-managed structure, each member had management power of the PLLC business. In addition, because there was no written operating agreement, the court had no other evidence of a limitation on a member's management authority. In addition, the evidence showed that the members actually did participate in management by determining their respective distributive shares, borrowing money, making employment-related decisions, supervising non-partner attorneys of the firm, and signing checks. The court also noted that a limited partnership must have at least one general partner and one limited partner, but the facts revealed that all members conducted themselves as general partners with identical rights and responsibilities. In addition, before becoming a PLLC, the law firm was a general partnership. After the change to the PLLC status, their management structure did not change.

> **Note.** The Tax Court did not mention the Proposed Treasury Regulations, but even if they had been taken into account, the outcome of the case would have been the same. Member-managed LLCs are subject to SE tax because all members have management authority.

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54. IRC §469(h)(5).

55. *Castigliola et al. v. Comm'r,* TC Memo 2017-62 (Apr. 12, 2017).

In *Soroban Capital Partners, LP v. Comm'r,*[56] the Tax Court issued a fully reported opinion (meaning it is of national significance in all jurisdictions) taking *Castigliola* one step further and holding that creating a limited partner interest under state law is not necessarily enough to have a limited partner interest for SE tax purposes. Soroban was a limited partnership that made guaranteed payments and distributed ordinary income to its limited partners. However, Soroban excluded distributions of ordinary income to its limited partners from its computation of net earnings from self-employment. Its basis for doing so was that the limited partners' interests conformed to state law. The IRS disagreed, asserting that was not enough and that the functions and roles of the limited partners also had to be analyzed for SE tax purposes. The Tax Court agreed with the IRS.

The Tax Court was faced with the definition of a limited partner for purpose of the exception from SE tax under §1402(a)(13). The Tax Court noted that the proposed treasury regulations provided a definition, that Congress froze the finalization of the regulation for six months and has said very little about the issue since the freeze was lifted, and has not provided a definition. The Tax Court noted that it applied a "functional analysis" test in *Renkemeyer*, but that this was the first time the Tax Court was asked to determine the SE tax status of a limited partner in a state law limited partnership (having passed on the issue in a 2020 case). The Tax Court determined that the functional analysis test applied was based largely on statutory construction of §1402(a)(13), which excludes from SE tax "the distributive share of any item of income or loss of a limited partner, as such." The court concluded that the "as such" language meant there was not a blanket exclusion for a limited partner. Instead, the statute only applies to a limited partner that is **acting** as a limited partner. If a limited partner is anything more than merely an investor, SE tax applies to the partner's distributive share.

Note. The court noted that Soroban cited legislative history in an attempt to support its position, but that the legislative history actually supported the position of the IRS. The Tax Court also noted that Soroban put forth numerous other arguments, none of which were persuasive. Soroban even cited language in the instructions for Form 1065, *U.S. Return of Partnership Income,* which it claimed defined a limited partner. In response, the Tax Court noted that the definition did not purport to define a limited partner.

The Tax Court held that a functional inquiry into the roles and activities of Soroban's individual partners under §1402(a)(13) "involves factual determinations that are necessary to determine Soroban's aggregate amount of net earnings from self-employment." Accordingly, the Tax Court denied Soroban's motion for summary judgment and set forth the rule going forward in evaluating the application of SE tax for limited partners in professional service businesses.

OBSERVATIONS AND TAX PLANNING CONSIDERATIONS

The manager-managed LLC provides a better result than the result produced by the member-managed LLC for LLCs that are not service partnerships. For service partnerships, such as the PLLC in *Castigliola,* an S corporation achieves a better SE tax result. For an S corporation, reasonable compensation will need to be paid subject to SE tax, but the balance drawn from the entity can be received free from SE tax. However, for farming operations with land rental income, the manager-managed LLC can provide a better overall tax result than the use of an S corporation because of the ability to eliminate the NIIT.

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[56]. *Soroban Capital Partners, LP v. Comm'r,* 161 TC 12 (2023).

Practitioner Planning Tip

Practitioners should closely examine how involved limited partners are in the management of a partnership. Practitioners should also review limited partnership agreements to determine if the agreements contain provisions granting more power than what the caselaw and the IRS indicates is appropriate over managerial decisions. Such provisions can be amended by adding clauses that limit control. It is critical that a limited partner's conduct is consistent with that of a true limited partner.

Note. Presently, two additional limited partnership cases are docketed with the Tax Court on the same issue as discussed above.[57]

INFORMAL PARTNERSHIPS

A joint venture, or other contractual arrangement carried on for business purposes where the participants divide the profits, might create a separate entity for federal tax purposes.[58] But, a simple joint undertaking to share expenses does not create a separate entity for federal tax purposes.[59] Merely co-owning property that is maintained, kept in a state of repair, and rented out does not result in a separate tax entity.[60] Thus, if an owner or tenants in common of farmland lease it to a farmer under a cash rent or crop share lease, a separate entity is not necessarily created.[61]

A partnership is an association of two or more people to carry on as co-owners a business for profit.[62] Similarly, a business arrangement "may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom."[63] The existence of a written partnership agreement usually settles the question of whether the arrangement is a partnership. Unfortunately, relatively few farm or ranch partnerships are based upon a written partnership agreement, or as it is expressed in some cases, a set of articles of partnership.

Note. As an estate planning device, the partnership is generally considered to be less complex and less costly to organize and maintain than a corporation. A general partnership is comprised of two or more partners. There is no such thing as a 1-person partnership, and there is no maximum number of partners that can be members of any particular general partnership.[64]

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57. *Denham Capital Management, LP v. Comm'r,* Docket No. 9973-23 (filed Jun. 22, 2023); *Point72 Asset Management, LP v. Comm'r,* Docket No. 12752-23 (filed Aug. 11, 2023).

58. See, e.g., Treas. Reg. §301.7701-1(a)(2).

59. Ibid.

60. Ibid.

61. Ibid.

62. Uniform Partnership Act, §6; *Uniform Partnership Act (1997) (Last Amended 2013),* p. 11. Aug. 19, 2015. National Conference of Commissioners on Uniform State Laws. [www.uniformlaws.org/viewdocument/final-act-98?CommunityKey=52456941-7883-47a5-91b6-d2f086d0bb44&tab=librarydocuments] Accessed on Jul. 5, 2024. See §102(11).

63. Treas. Reg. §301.7701-1(a)(2).

64. Ibid.

Sometimes an interesting tax or legal issue arises as to whether a particular organization is, in fact, a partnership. Taxpayers may attempt to prove (or disprove) the existence of a partnership to split income and expense among several taxpayers in a more favorable manner[65] or establish separate ownership of interests for estate tax purposes. However, such strategies are not always successful.[66]

THE PROBLEMS OF AN ORAL ARRANGEMENT

Because a partnership is an agreement between two or more individuals to carry on as co-owners of a business for profit, a partnership generally exists when there is a sharing of net income and losses.[67] This agrees with the U.S. Supreme Court's definition of a partnership as the sharing of income and gains from the conduct of a business between two or more persons.[68] This rule has been loosely codified in IRC §761, which also includes a joint venture in the definition of a partnership.

Farm Leases

If there is no written partnership agreement, one of the questions that may arise is whether a landlord/tenant lease arrangement constitutes a partnership. Unfortunately, as mentioned previously, many farm partnerships and leases are based only on oral arrangements.

A **crop-share lease** shares gross income, but not net income because the tenant has some unique deductions that are handled differently than the landlord's.[69] For example, the landlord typically bears all of the expense for building maintenance and repair, but the tenant bears all the expense for machinery and labor. Thus, there is not a sharing of net income, and the typical crop-share lease is, therefore, not a partnership.

Likewise, a **livestock share lease** is usually not a partnership because both the landlord and the tenant have unique expenses. However, if a livestock share lease or a crop-share lease exists for some time and the landlord and tenant start pulling out an increased amount of expenses and deducting them before dividing the remaining income, then the arrangement will move closer to partnership status. When the arrangement arrives at the point where there is a sharing of net income, a partnership exists. With a general partnership, the partners have unlimited liability. Because of the fear of unlimited liability, landlords prefer to have written into crop-share and livestock-share leases a provision specifying that the arrangement is not to be construed as a partnership.[70]

Note. A partnership can exist in certain situations based on the parties' conduct rather than intent. State law can play a significant role and should be examined. In Kansas, for example, the form of property ownership generally does not, by itself, constitute a partnership.[71] Thus, forms of ownership of property (including joint ownership) do not by themselves establish a partnership "even if the co-owners share profits made by the use of the property."[72] Also, if a share of business income is received in payment of rent, a presumption that the parties would otherwise be in a partnership does not apply.[73]

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65. See, e.g., *Holdner v. Comm'r*, 483 Fed.Appx. 383 (9th Cir. 2012), *aff'g* TC Memo 2010-175 (Aug. 4, 2010).

66. See, e.g., *Hohl v. Comm'r,* TC Memo 2021-5 (Jan. 13, 2021).

67. See, e.g., *In re Estate of Humphreys*, No. E2009-00114-COA-R3-CV (Tenn. Ct. App. Oct. 28, 2009).

68. *Comm'r v. Culbertson*, 337 U.S. 733 (1949).

69. See *Illinois Crop-Share Cash Farm Lease.* Farmdoc. [farmdoc.illinois.edu/assets/legal/form/Crop_Share_Lease.pdf] Accessed on Jul. 29, 2024.

70. See *Illinois Livestock Share Lease.* Farmdoc. [farmdoc.illinois.edu/assets/legal/form/Livestock_Share_Lease.pdf] Accessed on Jul. 29, 2024.

71. See, e.g., Kan. Stat. Ann. §56a-202.

72. See, e.g., Kan. Stat. Ann. §56a-202(c)(1).

73. See, e.g., Kan. Stat. Ann. §56a-202(c)(3)(iii).

TAX CLASSIFICATION

While the circumstances of a particular arrangement are to be considered, the primary question is "whether the parties intended to, and did in fact, join together for the present conduct of an undertaking or enterprise."[74] If a business arrangement is properly classified as a partnership for tax purposes, a partner is taxed only on their distributive share of the partnership's income.

Luna Factors

The Tax Court, in *Luna v. Comm'r,*[75] set forth eight factors to consider in determining the existence of a partnership for tax purposes. In *Luna,* the Tax Court considered whether the parties in a business relationship had informally entered into a partnership under the Tax Code, allowing them to claim that a payment to one party was intended to buy a partnership interest. To determine whether the parties formed an informal partnership for tax purposes, the Tax Court asked, "whether the parties intended to, and did in fact, join together for the present conduct of an undertaking or enterprise." The Tax Court listed non-exclusive factors to determine whether the intent necessary to establish a partnership exists.

The eight factors set forth in *Luna* are the following.

1. The agreement of the parties and their conduct in executing its terms
2. The contributions, if any, which each party has made to the venture
3. The parties' control over income and capital and the right of each to make withdrawals
4. Whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other who received contingent compensation in the form of a percentage of income in exchange for their rendered services
5. Whether business was conducted in the joint names of the parties
6. Whether the parties filed federal partnership returns or otherwise represented to the IRS or to persons with whom they dealt that they were joint ventures
7. Whether separate books of account were maintained for the venture
8. Whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise

The Tax Court applied the *Luna* factors in *White v. Comm'r,*[76] where Mr. White was approached by his ex-wife about forming a mortgage company and, along with their respective spouses, they orally agreed to work together in the real estate business in 2010 or 2011. The business was conducted informally and they did not consult any tax professionals. In 2011, Mr. White withdrew funds from his retirement account to support the business. His ex-wife and her new husband did not make similar financial contributions. Each of the "partners" handled various aspects of the business. Mr. White initially used his personal checking account for the business until business accounts could be opened. Some accounts listed Mr. White as "president" and his wife as treasurer, but other business accounts were designated as "sole proprietorship" with Mr. White's name on the account. Mr. White controlled the business funds and used business accounts to pay personal expenses and personal accounts to pay business expenses. Records were not kept of the payments. Business funds were also used to pay his ex-wife's personal expenses.

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74. Ibid.

75. *Luna v. Comm'r,* 42 TC 1067 (1964).

76. *White v. Comm'r,* TC Memo 2018-102 (Jul. 3, 2018).

The Tax Court applied the *Luna* factors and concluded that the business was **not a partnership** for tax purposes. The Tax Court determined that all but one of the *Luna* factors supported a finding that a partnership did not exist.

- The parties must have complied with the terms of a partnership agreement.
- There was no equal division of profits.
- The parties withdrew varying sums from the business.
- Mr. White claimed personal deductions for business payments.
- Mr. White's ex-wife and her new spouse could have received income from sources other than their share of the business income.
- There was no explanation for how payments shown on his ex-wife's return ended up being deposited into the business bank account.

Alternatively, the court concluded that even if a partnership existed, there was no reliable evidence of the partnership's total receipts to support an allocation of income different from the amounts that the IRS had determined by its bank deposits analysis.

When applying the *Luna* factors to typical farming/ranching arrangements, it is relevant to ask the following.

- Was a Form 1065 filed for any of the years at issue? Such filing is required for either a partnership or a joint venture.
- Did the parties commingle personal and business funds?
- Were any partnership bank accounts established?
- Was there any distinct treatment of income and expense between business and personal expenses?
- How do the parties refer to themselves to the public?
- How do the parties represent themselves to the Farm Service Agency?
- Are the business assets co-owned?

SE TAX

SE tax is imposed on a taxpayer's net earnings from a trade or business that the taxpayer conducts and are known as net earnings from self-employment.[77] Net earnings from self-employment includes a partnership member's distributive share of income or loss, whether distributed or not, from the partnership's trade or business that are not required to be separately stated.[78]

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> **Note.** An individual who received a partnership interest by gift in a partnership where capital is not a material income-producing factor is not recognized as a partner for SE tax purposes.

When computing net earnings from self-employment, a partner must take into account that partner's distributive share of the partnership business earnings, regardless of the partner's lack of active participation in the business.[79]

77. IRC §1402.

78. IRC §1402(a). For items that must be separately stated, see IRC §702(a)(8). The rule does not distinguish between the partnership's earned and unearned income. However, long-term capital gains, interest, rents, and royalties are separately stated items, and therefore, **are not** taken into account in computing the partners' net earnings from self-employment. See, e.g., *Pugh v. Comm'r*, TC Memo 1981-448 (Aug. 24, 1981).

79. See, e.g., *Estate of Ellsasser v. Comm'r*, 61 TC 241 (1973); *Norwood v. Comm'r*, TC Memo 2000-84 (Mar. 13, 2000).

Example 7. Farmer Seth died, and his estate passed to his wife, Azura, and his son, Enosh. Azura and Enosh continued the farming operation together as an informal partnership for their joint profit, but Enosh made all the key managerial decisions. Even though Azura was not active in the farm business, her distributive share constitutes net earnings from self-employment.[80]

Other Situations

When computing net earnings from self-employment, a current-year partnership loss that is disallowed to a partner under the passive activity loss (PAL) rules is not taken into account in computing that partner's net earnings from self-employment. An earlier year's loss that was disallowed to a partner under the PAL rules and that was carried forward to another year is not taken into account in computing that partner's net earnings from self-employment until the tax year in which the earlier year's loss is allowed to that partner.[81]

For partnerships in a community property state, if a partner's share of partnership income or loss is community income, it is not net earnings from self-employment in the hands of the partner's spouse.[82]

Informal joint ventures can also result in a partnership for tax purposes. In *Methvin v. Comm'r*,[83] Mr. Methvin acquired a small percentage in the working interests of oil and gas activities that were not part of any business organization registered under state law. Instead, the activities were governed by an operating agreement Mr. Methvin entered into with an operating company. Under the agreement, Mr. Methvin had no right to participate in management and had no knowledge or expertise in the oil industry. He only had the right to enter the property to inspect the operations, get any information reasonably requested about development and operation, and inspect the operating company's records. Based on his lack of participation in the activity and the fact that he did not even know what the working interest owners were doing with the activity, Mr. Methvin did not report his income from the venture as net earnings from self-employment.

The Tax Court disagreed with Mr. Methvin, determining that the working interest owners and the operator created a joint venture for the operation of the wells meeting the definition of a partnership. Consequently, the net income Mr. Methvin received from his interests was SE income.

Note. If a partner's tax year is different from the partnership's tax year, the partner includes in net earnings from self-employment their distributive share of income or loss of the partnership's tax year that ends with or within the partner's tax year.[84]

SMALL PARTNERSHIPS

If a business activity conducted by at least two persons is deemed to be a partnership, a return must be filed for each tax year that reports the items of gross income and allowable deductions.[85] If a partnership return is not timely filed in 2025 (including extensions) or is timely filed but is inadequate,[86] a monthly penalty is triggered that equals $245 multiplied by the number of partners during any part of the tax year for each month (or fraction thereof) for which the failure continues.[87] However, the penalty is capped at 12 months. The partnership is also potentially subject to IRS-specified audit procedures.

80. See, e.g., Rev. Rul. 54-613, 1954-2 CB 269.

81. TAM 9750001 (Aug. 15, 1997).

82. IRC §1402(a)(5)(B).

83. *Methvin v. Comm'r,* TC Memo 2015-81 (Apr. 27, 2015), *aff'd* 653 Fed.Appx. 616 (10th Cir. 2016).

84. Treas. Reg. §1.1402(a)-2(e).

85. IRC §§761(a) and 6031(a).

86. Thus, the return does not contain the information required by IRC §6031.

87. IRC §6698(b); Rev. Proc. 2016-55, 2016-45 IRB 707, §3.49.

Audit Procedures

The entity is also subject to the Bipartisan Budget Act of 2015[88] (BBA) audit rules for partnerships under which the partnership must designate a partnership representative to act on behalf of the partnership during an audit. However, IRC §6221(b) allows certain small partnerships to elect out of having the BBA apply on a timely filed partnership return for the tax year to which the election applies, including extensions.[89]

> **Note.** A partnership that fails to file a timely partnership return cannot make an election out for that tax year. The IRS did not prescribe the form or manner for this notification.

A partnership is eligible to elect out of the BBA if both of the following apply.

- All the partners are individuals, C corporations (including a foreign entity that would be treated as a C corporation, if domestic), S corporations, or the estate of a deceased partner. Partnerships with partners that are disregarded entities are not eligible to elect out of the BBA.
- The partnership is required to file 100 or fewer Schedules K-1.

If a partnership that elects out of the BBA (non-BBA partnership) is audited, each partner of the non-BBA partnership potentially is subject to a separate audit with respect to partnership-related items. If the partnership does not elect out of the BBA and instead elects to pay any additional tax determined from an audit, the tax will be assessed at the highest rate in effect for the reviewed year. This result may be simpler in form, but could generate a higher tax liability than if the additional tax is applied to each partner.

> **Note.** The election is made by checking the designated box on Form 1065, Schedule B, *Other Information,* and by completing Form 1065, Schedule B-2, *Election Out of the Centralized Partnership Audit Regime*.

Exception

An exception from the penalty for failing to **file** a partnership return and the BBA audit procedures could apply for many small business partnerships and farming operations. However, it is important to understand the scope of the exception, and what is still required of such entities even if a partnership return is not filed. In many instances, such entities may find that filing a partnership return in any event is a more practical approach.

If the entity is deemed to be a partnership and fails to file a partnership return, the penalty for failure to file is assessed against the partnership. While there is not a statutory exception to the penalty, it is not assessed if it can be shown that the failure to file was due to **reasonable cause.**[90] The taxpayer bears the burden to show reasonable cause based on the facts and circumstances of each situation.[91] On the reasonable cause issue, the IRS, in Rev. Proc. 84-35,[92] established an exception from the filing requirement for a **small partnership.** Under the Rev. Proc., an entity that satisfies the requirements to be a small partnership will be considered to meet the reasonable cause test and will not be subject to the penalty imposed by IRC §6698 for the failure to file a complete or timely partnership return. However, the Rev. Proc. noted that each partner of the small partnership must fully report their shares of the income, deductions, and credits of the partnership on their timely filed income tax returns.

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88. *Bipartisan Budget Act of 2015,* PL 114-74.

89. If the partnership elects out of the BBA, it must disclose to the IRS the name and tax identification number of each partner and notify its partners that it made the election out of the BBA within 30 days of making the election.

90. IRC §6689(a).

91. See, e.g., SCA 200135029 (Aug. 31, 2001).

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

Under the BBA, a **small partnership** must satisfy the following five requirements.[93]

1. The partnership must elect out of the BBA for the tax year.
2. The partnership must have 100 or fewer partners.

> **Caution.** The definition of a **small partnership** was changed by BBA to "100 or fewer" but the penalty exception rules are contained in Rev. Proc. 84-35.

3. Each of the partners must be individuals, C corporations, foreign entities that would be treated as C corporations if they were domstic S corporations, or estates of deceased partners.
4. The election is made with a timely filed return for the tax year and includes the name and taxpayer identification number of each partner.
5. The partnership notifies each partner of the election.

Consequently, if a partner has transferred the partnership interest to a revocable living trust or owns the partnership interest through a single member LLC, the partnership does not qualify as a small partnership for purposes of §6698.[94]

Typically, the IRS will have asserted the §6698 penalty for the failure to file a partnership return. The penalty can be assessed **before** the partnership has an opportunity to assert reasonable cause or after the IRS has considered and rejected the taxpayer's claim.[95] When that happens, the partnership must request reconsideration of the penalty and establish that the small partnership exception applies so that reasonable cause exists to excuse the failure to file a partnership return.[96]

As noted previously, even though the failure to file penalties can be avoided via the small partnership exception, it is still necessary that all items of income, deductions, and credit, etc. from the partnership are properly reported on a timely basis on the partners' individual tax returns. In addition, the partnership allocation percentages must be the same for all partnership tax attributes. Furthermore, the tax preparer will have to split income and expenses into two or more separate Schedules F, *Profit and Loss From Farming,* and allocate depreciation and other tax items amongst the partners. Therefore, in most instances, it will be easier to report all of this information on a partnership tax return compared to making the same calculations and allocating individual items of income and expense to each partner.

Typically, the small partnership exception is limited in usefulness to those situations where the partners are unaware of the partnership return filing requirement or are unaware that they have a partnership for tax purposes and the IRS asserts a penalty for failing to file a partnership return. In those situations, the partnership can use the exception to show reasonable cause for the failure to file a partnership return. But, even if the exception is deemed to apply, the IRS can require that the individual partners prove that they have properly reported all tax items on their individual returns.

> **Note.** If the small partnership exception applies, it does **not** mean that the small partnership is not a partnership for tax purposes.[97] It only means that the small partnership is not subject to the penalty for failure to file a partnership return and the BBA audit procedures.[98]

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93. IRC §§6221(b)(1)(A)–(E).

94. The treatment of a grantor trust and single-member LLC as disregarded entities does not apply for the determination of whether the partnership interest is held by an individual. Treas. Reg. §301.6231(a)(1)–1(a)(2) treats a single-member LLC as a "pass-through" partner. See Rev. Rul. 2004-88, 2004-32 IRB 165.

95. See SCA 200135029 (Aug. 31, 2001).

96. The IRS has indicated that it could send a notice to a partnership that failed to file a return along with a questionnaire that could be completed and returned to the IRS so that the IRS could determine whether the penalty can be excused. See SCA 200135029 (Aug. 31, 2001).

97. This argument was tried by the Chapter 12 bankrupt debtor's expert witness in *In re Hemann*, No. 11-00261 (Bankr. N.D. Iowa Apr. 3, 2013). A Chapter 12 debtor sold an interest in a farm partnership which met the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) definition of a small partnership. The debtor's expert witness argued that, as a result, the debtor's partnership was to be treated as non-existent with the result that the debtor's income arose from the sale of a personal interest in a farm partnership rather than a capital interest in the partnership, and qualified as the sale of a "farm asset" for purposes of 11 USC §1222(A)(2)(a). The court rejected the expert's argument as irrelevant and stated, "...the decision here will not rely in any way on his testimony." The court noted there was a large amount of case law and legislative language contrary to the position of the debtor's expert.

98. See, e.g., *Cahill v. Comm'r*, TC Memo 2013-220 (Sep. 18, 2013).

LIABILITY AND OTHER LEGAL CONCERNS

Much of the concern about whether an informal farming arrangement could be construed legally as a partnership is the fear of **unlimited liability.** Partners are **jointly and severally liable** for the debts of the partnership that arose out of partnership business. The fear of unlimited liability causes parties to have provisions specifying that the arrangement is **not** to be construed as a partnership written into crop-share and livestock-share leases.

There are many scenarios in which legal issues arise over the question of whether a partnership exists. For example, in *Farmers Grain Co., Inc. v. Irving,*[99] Farmers Grain extended credit to Mr. Foster who was a tenant under an oral livestock-share lease. Upon default of the loan, Mr. Foster filed for bankruptcy and Farmers Grain tried to bind the Irvings (the landlords) to the debt under a partnership theory. The court held that a partnership had not been formed where the landlord did not participate in the operation, no joint bank accounts were established, and gross returns were shared rather than net profits.

In *Tarnavsky v. Tarnavsky,*[100] the court determined that a partnership did exist where the farming operation was conducted for a profit, the evidence established that the parties involved intended to be partners and business assets were co-owned.

Oral business arrangements can also create unanticipated problems if one of the parties involved in the business dies. In *In re Estate of Palmer,*[101] the court determined that a partnership existed even though title to the real estate and the farm bank account were in joint tenancy. As such, the surviving spouse of the deceased "partner" was entitled to half of the farm assets instead of the land and bank account passing to the surviving joint tenant.

A tax issue that may arise is the determination of the properly allowed IRC §179 deduction. If multiple joint owners in separate sole proprietorships with multiple §179 deductions become classified as partners in a partnership, only one §179 deduction limit applies.[102]

SUSTAINABLE AVIATION FUEL TAX CREDIT

A new sustainable aviation fuel (SAF) credit was created under the Inflation Reduction Act of 2022.[103] The new credit is contained in IRC §40B. The Inflation Reduction Act also modified the existing credit contained in IRC §6426(k). The new credit has implications for corn and soybean farmers and biofuel plants, and will force a closer examination of the carbon intensity score of the production of corn and soybeans.

The SAF credit applies to a qualified fuel mixture containing sustainable aviation fuel for certain sales or uses in calendar years 2023 and 2024.[104] The SAF credit is $1.25 for each gallon of sustainable aviation fuel in a qualified mixture.[105] To qualify for the credit, the sustainable aviation fuel must have a minimum reduction of 50% in lifecycle greenhouse gas emissions.[106] Additionally, there is a supplemental credit of one cent for each percent that the reduction exceeds 50% until the credit is maximized at $1.75 per gallon.[107]

99. *Farmers Grain Co., Inc. v. Irving,* 401 N.W.2d 596 (Iowa Ct. App. 1986).
100. *Tarnavsky v. Tarnavsky*, 147 F.3d 674 (8th Cir. 1998).
101. *In re Estate of Palmer,* 708 P.2d 242 (Mont. 1985).
102. IRC §179(d)(8); Treas. Reg. §§1.179-2(c)(2)(i) and (3).
103. *Inflation Reduction Act of 2022,* PL 117-169, §§13203 and 40007, which introduced the "Fueling Aviation's Sustainable Transition (FAST)" grant program and provided $244.5 million in grants for SAF-related "production, transportation, blending, or storage."
104. IRC §§40B(f) and (h).
105. IRC §40B(a)(2)(A).
106. IRC §40B(d)(1)(D).
107. IRC §40B(b).

IRS GUIDANCE

In late 2022, the IRS provided guidance on the related credit and payment rules under IRC §§34(a)(3), 38, 87, and 6427(e)(1), as well as the registration requirements contained in IRC §4101.[108] In the notice, the IRS provides a safe harbor for calculating the lifecycle greenhouse gas emissions reduction percentage, and also clarifies what constitutes sustainable aviation fuel and a qualified mixture. In addition, the notice explains that a claimant may choose to claim the SAF credit through the excise tax system or as a general business credit that is nonrefundable and must be included in income.

> **Note.** As noted, to qualify for the credit, SAF must have a minimum reduction of greenhouse gas emissions of 50% when compared to the production of petroleum-based jet fuel. Presently, the airline industry has committed to using three billion gallons of SAF annually by 2030 (10% of anticipated fuel needs).

> **Note.** The credit is claimed by a taxpayer that produces the fuel at a qualified facility, either an ethanol or biofuel plant.[109] These qualified facilities will pay farmers that adopt carbon-reducing farming practices that lead to the facility qualifying for the credit, and farmers can qualify for USDA grants to adopt practices that reduce carbon emissions (e.g., planting cover crops). The fuel producer must be registered with the IRS at the time the fuel is produced.[110]

USDA PILOT PROGRAM[111]

In early 2024, the IRS provided additional guidance and safe harbors. The notice specified the 40BSAF-GREET (Greenhouse gases, Regulated Emissions, and Energy use in Technologies) 2024 model as a qualifying method to calculate the emissions reduction percentage and for the corresponding unrelated party certification to qualify for SAF credits. The notice also specified the use of the USDA's Climate Smart Agriculture Pilot Program to further reduce the lifecycle greenhouse gas emissions reduction percentage calculated using 40BSAF-GREET 2024 for domestic soybean and domestic corn feedstocks, and for certifying the related requirements. This program establishes Climate Smart Agriculture (CSA) practices for cultivating domestic corn (CSA corn) and domestic soybeans (CSA soybeans) for use as sustainable aviation feedstocks.

> **Observation.** The bottom line is that the only way ethanol plants qualify for the SAF tax credit is that corn must be produced in a particular manner — no till, cover crop, and the precision placement of nitrogen. Corn cannot be "identity preserved" for the SAF credit in the current distribution system. Interestingly, the GREET model does not include the fuel usage necessary to plant the cover crop.

Only corn and soybeans are eligible for the program. To qualify for CSA practices, producers must engage in three activities for corn (no-till, cover crops, and enhanced efficiency nitrogen application). Soybean producers must only utilize no-till and cover crops. Practices are to be applied at the field scale. The definitional requirements are lengthy and specific.

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108. IRS Notice 2023-6, 2023-2 IRB 328. The IRS later issued Notice 2024-6, 2024-2 IRB 348 that superseded Notice 2023-6 in which it indicated that the GREET model at that time did not qualify for IRC §40B and indicated that a revised model would be issued. The automatic safe harbor qualifiers were biomass-diesel or advanced biofuel (eligible for a $1.25/gallon credit), and cellulosic biofuel or cellulosic diesel (eligible for a $1.35/gallon credit).

109. The optimal manner for an ethanol plant to reduce its carbon intensity score is to sequester CO2. That can be done either by direct capture or by pipeline. If by pipeline, the carbon intensity score drops by 30%. No pipeline will be in place before 2028 and the IRC §45Z credit expires at the end of 2027.

110. IRS Notice 2024-49, 2024-26 IRB 1781.

111. IRS Notice 2024-37, 2024-21 IRB 1191.

Cover crops must meet the following requirements.

- Plant species, seedbed preparation, seeding rates, seeding dates, seeding depths, fertility requirements, and planting methods must be consistent with applicable local criteria and soil/site conditions.
- Select species must be compatible with other components of the cropping system.
- Herbicides used with crops must be compatible with cover crop selections and purpose(s).
- Cover crops may be established during the fallow season prior to planting the feedstock crop, or companion planted or relay-planted into production crops.
- Cover crop residue must not be burned.
- The method and timing of termination must be determined to meet the grower's objective and the current Natural Resource Conservation Service (NRCS) cover crop termination guidelines.
- Must ensure that the planned management of grazed or hayed cover crops will not compromise the soil health and organic matter content.
- Cover crops must not be harvested for seed.
- If the specific rhizobium bacteria for the selected legume are not present in the soil, treat the seed with the appropriate inoculum at the time of planting.

Records must be maintained for each CSA practice and a producer must attest to compliance in certification documents. Thus, an SAF producer (i.e., a "qualified facility") must:

- Have direct contact with the farmer;
- Collect and maintain the certificate for CSA crops from the farmer;
- Maintain records in accordance with Appendix A of Notice 2024-37; and
- Allow records to be available for certification and be subject to audits.

Observation. In essence, corn qualifies for a 10% emissions reduction if a farmer utilizes no-till or strip-till practices, plants cover crops, and uses enhanced low-carbon fertilizer. Soybeans qualify for a 5% emissions reduction if the farmer uses no-till and plants cover crops.

The USDA's goal is to sign-up at least 60,000 farmers and enroll 25 million acres that would sequester in excess of 60 million metric tons of carbon dioxide. Some states, such as Iowa, incentivize the planting of a cover crop at the rate of $30 per acre.[112] In addition, the USDA's Risk Management Agency offers crop insurance discounts of $5 per acre for planting fall cover crops in some states.

Note. Corn and soybean farmers must know their **carbon intensity score.** The current average corn carbon intensity score is 29. For every point below 29, the possible credit value is about $.054/bushel. If the carbon intensity is zero, the possible credit value is $1.57/bushel. It is possible that the carbon intensity score could be negative — which would increase the possible credit.[113]

112. *Secretary Naig Announces Increased Cover Crop Cost-Share Incentives.* May 7, 2024. Iowa Department of Agriculture & Land Stewardship. [iowaagriculture.gov/news/cover-crop-CS-incentives-increase] Accessed on Aug. 8, 2024.

113. A professional agronomist can determine a farmer's carbon intensity score.

DIFFERENT CREDIT POST-2024

As noted previously, the credit under §40B applies through the end of 2024. Subsequently, the credits under IRC §45Z apply to transportation fuel sold through 2027. To be eligible for the credit, the transportation fuel must be produced by the taxpayer at a qualified facility and sold by the taxpayer as required by §45Z. Beginning in 2025, the §45Z credit can be up to $1 per gallon for any biofuel with a carbon intensity score at least 50% lower than a petroleum-based fuel. The rate is increased to $1.75 per gallon for sustainable aviation fuel. Once the 50% level is attained, every point of carbon intensity reduction is worth $.02 per gallon.[114] In addition, qualifying for the §45Z credit requires the taxpayer to meet prevailing wage and be subject to apprenticeship programs to qualify for the maximum possible credit.

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 are 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. This section focuses on the impact on retailers.

INCOME RECOGNITION

A retailer may receive an advanced payment for loyalty or reward points, discount vouchers, and the like. In general, an income item is included in gross income for tax purposes in the year in which the taxpayer receives it, unless the taxpayer's method of accounting dictates that it should be accounted for differently.[115] Generally, an accrual-method taxpayer recognizes income when all of the events occur that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.[116] All of the events occur at the earliest of when:

- Payment is due;
- Payment is made; or
- The required performance takes place.[117]

However, IRC §451(c) requires an accrual-method taxpayer to take advance payments into income in the tax year of receipt with an election to defer inclusion to the next tax year if the income is also deferred for applicable financial statement purposes.[118] Prop. Treas. Reg. §1.451-8(b)(1) provides the definition of what an "advance payment" is for this deferral and includes gift cards as well as reward and loyalty programs. Thus, a retailer may treat these items as future revenue and not as an accrued expense.[119]

> **Note.** Under the proposed regulation, a taxpayer without an applicable financial statement that receives advance payments must include them in income in the tax year of receipt, to the extent earned, with the balance accounted for in the next succeeding tax year.

114. For example, a 60% reduction compared with petroleum-based fuel garners a credit of $.20 per gallon, or $.35 per gallon for sustainable aviation fuel. A lower credit applies to biofuels and a higher credit for SAF. In addition, the taxpayer must have less than 50kg per million BTU of CO2 to qualify for any credit.

115. IRC §451.

116. Treas. Reg. §1.451-1.

117. See, e.g., Rev. Rul. 2003-10, 2003-1 CB 288.

118. See also Rev. Proc. 2004-34, 2004-22 IRB 991.

119. The preamble to the proposed regulation states that there is no corresponding offset for the cost of goods sold. Thus, it is possible that a taxpayer would recognize income in one year, but not recognize a corresponding offset for the cost of goods sold until a later year.

Economic Performance

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's 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.[120] However, for an accrual-method taxpayer, the taxpayer's liability becomes fixed (and a deduction can be claimed) when the customers **earn** the rewards.[121] 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.[122]

Two Requirements. 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. Most retailer customer loyalty programs likely satisfy both tests. The IRS, in a matter involving an accrual basis supermarket chain that had a rewards program allowing customers to receive a certain amount of gas for free depending on purchases of products, stated that the supermarket could take a current deduction for the value of the gas rewards.[123] The IRS concluded that the gas rewards were being redeemed for other property.[124] The rewards were issued on the basis of purchases.

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.[125]

Timing of Deduction. 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 are not fixed and determinable and do not otherwise meet the economic performance rules of the all-events test.[126]

Retailers with loyalty programs that satisfy the two tests of Treas. Reg. §1.451-4 may find the use of 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. The method change is achieved by using the advance consent procedures of Rev. Proc. 97-27.[127] If a loyalty program does not meet the requirements to use Treas. Reg. §1.451-4, the redemption liability is treated as a deduction and not as an exclusion from income. Thus, the redemption liability is taken into account in the tax year in which the liability becomes fixed and determinable and economic performance occurs under IRC §461. Generally, that is the year in which the customer redeems the loyalty rewards.

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120. Ltr. Rul. 200849015 (Dec. 5, 2008).
121. *Giant Eagle, Inc. v. Comm'r*, 822 F.3d 666 (3d Cir. 2016), *rev'g* TC Memo 2014-146 (Jul. 23, 2014).
122. AOD 201603 (Oct. 3, 2016).
123. FSA 20180101F (Nov. 7, 2017).
124. Treas. Reg. §1.451-4(a)(1).
125. IRC §461.
126. Treas. Reg. §1.451-4(a)(1).
127. Rev. Proc. 97-27, 1997-1 CB 680, modified by Rev. Proc. 2002-19, 2002-1 CB 696.

Recent Case

In *Hyatt Hotels Corporation & Subsidiaries v. Comm'r*,[128] Hyatt established a "Gold Passport" rewards program in 1987 that provided its customers with reward points redeemable for free future stays at its hotels. Hyatt owns about 25% of its branded hotels with the balance owned by third parties who license Hyatt's intellectual property and/or management services. Under the program, Hyatt required hotel owners to make payments into an operating fund (Fund) when a customer earned points. Hyatt was the custodian of the Fund and compensated a hotel owner out of the Fund when a guest redeemed reward points for free stays. Hyatt determined the rate of compensation. Hyatt invested portions of the Fund's unused balance in marketable securities which generated gains and interest. In 2011, Hyatt changed the compensation formula to increase the amount it could hold for investment. Hyatt also used the Fund to pay administrative and advertising expenses that it determined were related to the rewards program.

The points could not be redeemed for cash and were not transferrable. In addition, any particular member hotel could not take back the payments made to the Fund except by providing free stays to members. The Fund allocated 46-61% of its amount to reward point redemptions. Fund statements described the funds as belonging to the hotel owners that paid into the Fund. Hyatt's Form 10-K, *Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934,* filed with the Securities and Exchange Commission (SEC), treated the Fund as a "variable interest entity" eligible for consolidated reporting. When Hyatt provided management services to member hotels, payments into the Fund were reported as "expenses."

Hyatt did not report the Fund's revenue as gross income with respect to the hotels it did not own. Additionally, it did not claim any deductions for expenses paid on the basis that Hyatt was a mere trustee, agent, or conduit for hotel owners rather than a true owner of the Fund. However, Hyatt did claim deductions for its share of program expenses associated with the 25% of hotels it owned. Hyatt reported Fund assets and liabilities on a consolidated basis on Schedule L, *Balance Sheets per Books*. Hyatt's Form 1120, *U.S. Corporation Income Tax Return,* did not state that it was using the trading stamp method or include any statement concerning Treas. Reg. §1.451-4. Hyatt's position was that third-party owners should make their own decision about the tax treatment of the money they paid to the Fund.

> **Note.** Most third-party owners simply deducted payments to the Fund when paid regardless of whether economic performance would have occurred for expenses accrued for redemption, advertising, and operating costs.

The IRS audited Hyatt and took the position that Hyatt was using an improper accounting method. This triggered an IRC §481 adjustment requiring Hyatt to include the cumulative amounts from 1987 (Fund revenue less expenditures) in income. The IRS assessed an adjustment of $222.5 million and additional adjustments in 2010 and 2011. Hyatt disagreed and filed a Tax Court petition.

The Tax Court determined that the amounts Hyatt received related to the customer reward program (i.e., Fund revenue) were revenue includable in gross income because of Hyatt's significant control over the Fund. That control indicated that Hyatt had retained a beneficial interest in the Fund, and the exception under the **trust fund doctrine** established in *Seven-Up Co. v. Comm'r,*[129] did not apply. The trust fund doctrine allows a taxpayer to exclude from gross income funds received in trust, subject to a legally enforceable restriction that the funds be spent entirely for a specific purpose, where the taxpayer does not profit, gain, or benefit from spending the funds for that purpose. In *Hyatt,* the Tax Court determined that the trust fund doctrine did not apply because Hyatt:

- Mandated participation and payments into the Fund;
- Controlled the amounts of program payments to the Fund and the payments from the Fund;
- Made the decisions as to how Fund amounts were to be invested;
- Accrued interest and realized gains on investments in the Fund; and
- Decided whether Fund amounts would cover advertising and/or administrative costs.

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128. *Hyatt Hotels Corporation & Subsidiaries v. Comm'r,* TC Memo 2023-122 (Oct. 2, 2023).

129. *Seven-Up Co. v. Comm'r,* 14 TC 965 (1950), *acq.* 1950-2 CB 4.

In other words, Hyatt received more than "incidental and secondary" benefits from the Fund.

In addition, the Tax Court pointed out that Hyatt benefited directly from the Fund based, in part, on the Fund generating goodwill among customers leading to increased bookings and royalties and fees. Indeed, Hyatt owned approximately 25% of the hotels that paid into the Fund, which indicated a clear benefit to Hyatt's own interests.

However, in a major win for Hyatt, the Tax Court also determined that Hyatt's treatment of Fund revenue and expenses did **not** amount to the adoption of a method of accounting. Thus, no §481 adjustment was required. Hyatt's consistent and total exclusion of Fund revenue and expense did not involve timing and, therefore, was not a method of accounting. Hyatt had simply excluded the Fund amounts from gross income and would have continued to do so if the Fund had ended and the amounts in the Fund were distributed to member hotels.

Note. The normal statute of limitation of IRC §6501 does not apply when an accounting method change has occurred. If Hyatt had adopted an impermissible accounting method, the IRS would not have been time-barred to make adjustments.

As for the application of the **trading stamp method** of reporting income and expense, Hyatt claimed that Fund gross receipts should be offset by both the current year reward redemptions and the estimated cost of future tax year reward redemptions (i.e., an acceleration of deduction beyond actual program costs). The Tax Court disagreed on the basis that a hotel stay, which is either characterized as a license or a leasehold, would not qualify as merchandise, cash, or other property as the trading stamp method required. The Tax Court also clarified that "other property" for purposes of Treas. Reg. §1.451-4 includes property like merchandise or cash. "Other property" is not a hotel stay. It is, rather, tangible property.

Note. *Hyatt* is a good case for tax advisers with clients that offer loyalty reward programs to customers. Retail businesses offering such programs will want to ensure that their program is structured in a manner fitting within the trust fund doctrine's exception for excluding program funds from gross income. *Hyatt* is basically a win for the taxpayer, because most of the adjustments the IRS proposed were time-barred once the Tax Court determined that a method of accounting had not been adopted.

Note. For more information on the *Hyatt* case, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 10: Rulings and Cases.

BUY-SELL AGREEMENTS

A **buy-sell agreement** is a frequently used mechanism by a closely held farming or ranching business (as well as many non-farm businesses) to integrate the needs and capabilities of the business with the succession planning and transition objectives of the owners. A well-drafted buy-sell agreement can be a very useful document to assist in transitioning a family business from one generation to the next. It can also balance out inheritances among heirs by ensuring the heirs interested in running the family business end up with control of the business, and other heirs end up with non-control interests.

Common events that trigger buy-sell agreements are death, divorce, or bankruptcy. A buy-sell agreement can effectively provide a market for the ownership interests, limit transferability of those interests outside the immediate family, and establish a procedure for buying a deceased owner's interests which, in turn, can aid in establishing certainty as to the value of the shares for federal estate tax purposes. Likewise, when utilized properly, a buy-sell agreement may also provide estate tax valuation discounts.

Note. For more information on buy-sell agreements, including the issue with closely held corporations being named as a beneficiary of insurance policy proceeds to buy out a deceased shareholder, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 5: Agricultural Issues and Rural Investments.

VALUATION ISSUE

To be operational, the parties to a buy-sell agreement must have funds available to buy the stock at the time the agreement is triggered. Typically, life insurance is purchased for each business owner to cover the total purchase price (or at least the down payment of coverage). One approach is for each shareholder to buy, pay for, own, and be the beneficiary of a life insurance policy for each of the other shareholders. The surviving shareholders would then receive the proceeds when one shareholder dies and, if a cross-purchase (discussed later) is indicated and appropriate, use the proceeds as the necessary funds to carry out the buy-sell agreement. The surviving shareholders could also lend the proceeds to the corporation if a redemption agreement is utilized to enable the corporation to buy additional shares. Alternatively, the surviving shareholders could make capital contributions, which would have the effect of increasing each shareholder's stock basis.

There is a split of authority between the circuit courts of appeal on the issue of whether the policy proceeds are included in the corporate value as reflected in the stock base. If included, the enhanced value could trigger estate tax in the estate of the deceased shareholder and result in a decreased inheritance of the decedent's heirs. In essence, the issue is whether the redemption obligation of the corporation constitutes an offsetting corporate liability. The Eleventh Circuit has concluded the obligation is an offsetting liability that does not enhance the corporation's value.[130] The 9th Circuit had previously reached the same conclusion.[131]

However, in *Connelly v. U.S.,* the 8th Circuit reached a different conclusion.[132] The U.S. Supreme Court affirmed the decision and determined that the corporation's contractual obligation to redeem the deceased shareholder's shares at FMV was not a liability that decreased the value of those shares for purposes of the federal estate tax. The Supreme Court reasoned that the correct approach on valuation was to determine the value of the decedent's interest at the time of death, before the corporation spent $3 million on the redemption payment. The Court determined that a hypothetical buyer would treat the life insurance proceeds that would be used to redeem the decedent's shares as a net asset. This was the case because the redemption agreement specified that the insurance proceeds would be available to fund the redemption. This, in turn, indicated that the corporation would receive the proceeds and thereby increase the value of the deceased shareholder's shares.

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130. *Estate of Blount v. Comm'r*, 428 F.3d 1338 (11th Cir. 2005).

131. *Cartwright v. Comm'r*, 183 F.3d 1034 (9th Cir. 1999).

132. *Connelly v. U.S.*, 144 S. Ct. 1406, *aff'g* 70 F.4th 412 (8th Cir. 2023).

Note. In a footnote, the Court indicated that it was not holding that a redemption-style buy-sell agreement could never decrease corporate value. On this point, the Court stated that a redemption agreement could require a corporation to liquidate operating assets to pay for the shares, which would decrease the corporation's future earning capacity.[133]

Note. For more information on the *Connelly* case, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 10: Rulings and Cases.

Alternative Approaches

In light of the Supreme Court's decision in *Connelly,* a redemption buy-sell agreement should be avoided in situations where the inclusion of the life insurance proceeds in the value of the corporation would result in estate tax issues for the deceased shareholder's estate. Alternatives include a cross-purchase buy-sell agreement, a cross-purchase buy-sell agreement with an insurance LLC, and a cross endorsement buy-sell agreement.

Cross-Purchase Buy-Sell Agreement. This type of agreement is a contract between or among the owners (the business is not necessarily a party to the agreement) whereby each owner agrees to sell their shares to the other owners on the occurrence of specified events. With a cross-purchase agreement, unless the shareholder is a dealer in stock, any gain on the sale is a capital gain regardless of the character of the corporation's underlying assets.[134] For an estate that sells the stock shortly after the shareholder's death, no gain is recognized if the agreement sets the sale price at the date of death value.[135] The purchasing shareholders increase their basis in their total holdings of corporate stock by the price paid for the shares purchased under the agreement, even if the shares are paid for with tax-free life insurance proceeds.

Cross-Purchase Buy-Sell Agreement with a Life Insurance LLC. This approach involves establishing a cross-purchase agreement under which the owners agree to create an LLC for the purpose of holding life insurance policies related to the business. The LLC's operating agreement includes a provision specifying that the insurance policies are to not be included in the insured's estate, with the allocation of the death benefit flowing to the surviving members of the business. The operating agreement should state that the business purpose of the LLC is to facilitate the ownership succession plan of the related entity.

Note. A policy may be transferred to an LLC without triggering tax.[136] However, including other assets in the LLC in addition to the life insurance would help to support an argument, if challenged, that the LLC is a partnership under the transfer-for-value rules.[137]

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133. However, this would defeat the purpose of a buy-sell agreement for many closely held corporations, particularly farming and ranching corporations desiring to keep control of the corporation in the family for subsequent generations. The goal of a redemption-style buy-sell agreement is to utilize the life insurance proceeds to buy out the deceased shareholder's interest instead of (or at least before) liquidating corporate assets.

134. IRC §1221.

135. IRC §§1014 and 2032.

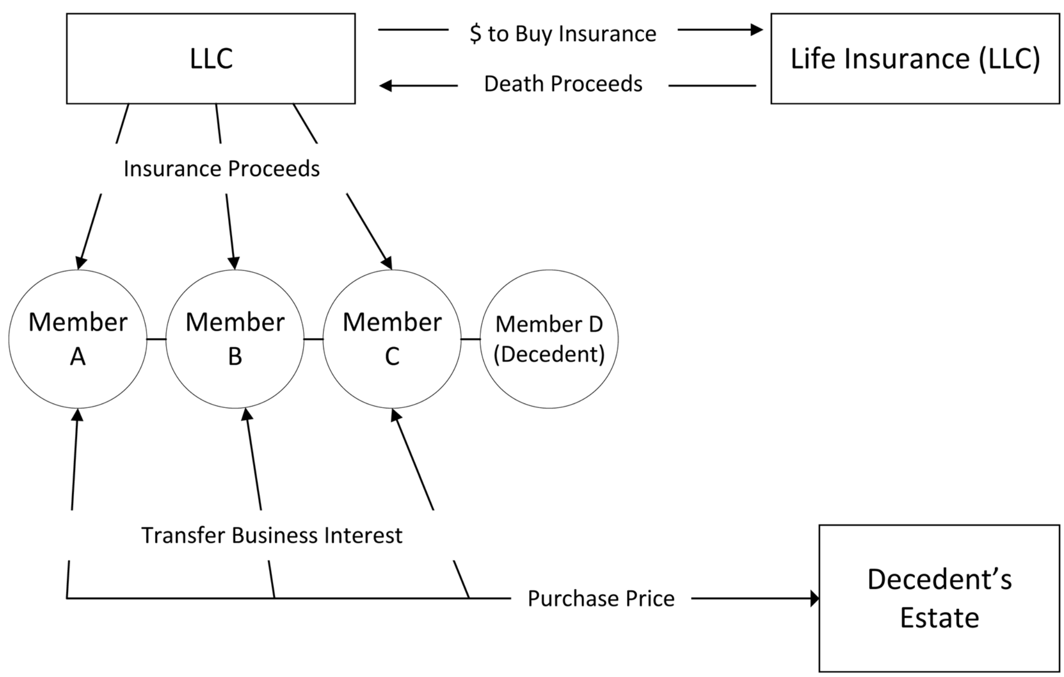
136. IRC §101(a)(2).

137. Ibid. Partnership tax status exempts transfers of interests in policies to the LLC or transfers of interests in the LLC to other members that would otherwise cause the death benefits to be taxable.

Another LLC should then be created, known as the "insurance LLC." The insurance LLC would name the other LLC as the beneficiary of the life insurance policies. The owners of the initial LLC should avoid being managers if the LLC is a manager-managed LLC. In addition, the insured should avoid having control over the policy or policies on the insured's life.[138] Member contributions to the LLC to pay policy premiums on the lives of other members are treated as contributions by non-insured members, which increases their respective tax capital accounts or a basis increase. Upon the insured's death, the insurer will divide the death benefits among the tax capital accounts of the surviving members in proportion to the premiums each respective member paid. The insurer also distributes the life insurance policy when a member dies. The remaining business owners buy the deceased member's interest in accordance with the terms of the buy-sell agreement. The decedent's ownership interest in the LLCs adjusts to FMV as of the date of death, and the death benefit to the beneficiaries increases their tax basis in the LLC. No income tax is triggered to the beneficiaries.

The following diagram illustrates the relationships among LLC members, the decedent's estate, the life insurance policy, and the flow of death proceeds.

Cross-Purchasing a Buy-Sell Agreement with a Life Insurance LLC



> **Note.** With this approach as diagramed, the decedent's estate would still include one-fourth of the value of the insurance premiums for federal estate tax purposes.

> **Note.** Generally, life insurance premiums are not deductible. They are tax-free unless the provisions of IRC §2042 are triggered.[139]

138. Likewise, the operating agreement should clearly bar members from acting with respect to insurance policies on their lives.

139. IRC §246(a)(1).

Cross Endorsement Buy-Sell Agreement.[140] With a cross-endorsement buy-sell agreement strategy, each business owner buys and is the owner of an insurance policy on their own life. Each owner then endorses a portion of the policy's death benefit to the other business owners, making them "renters" of the death benefit in proportion to the other business owners' ownership percentages in the business. Each policy owner pays the premiums while the other business owners pay the policy's owner an annual "rental charge" for the death benefit. This rental charge is equal to the economic benefit cost for the amount of death benefit endorsed to the "renter." The annual rental charge can be used to offset the premiums that the policy's owner must pay.

Upon a shareholder's death, the remaining owners buy the deceased owner's business interest from the estate with the death benefit paid to the remaining owners according to the amount endorsed to them.

Payment of the economic benefit amount under the "rental agreement" that accompanies a cross-endorsement agreement is taxable as ordinary income to the policy's owner. The economic benefit amount must be paid annually, in addition to the required premium payments, although the policy's owner can use the economic benefit amount received as an offset against the amount they have to pay as the premium.

Unless an exception is satisfied, a cross-endorsement arrangement can also trigger a violation of the transfer-for-value rule upon an insured's endorsement of the death benefit to another owner.

OPTIONS FOR RETIRING FARMERS (SELECTED TOPICS)

Retiring farmers have several options for succession planning and protecting their assets. This section compares charitable remainder trusts (CRTs) and cash balance plans, and installment sales as three such options.

CRTs VERSUS CASH BALANCE PLANS

> **Note.** For more information on CRTs, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 5: Agricultural Issues and Rural Investments.

A common tax problem farmers encounter in their last few years of actively farming involves the practice of deferring grain sales from the prior year. When the last harvest occurs, the farmer faces the prospect of having the income from the sale of that last crop and the income from the deferred grain sales from the previous year being reported into income in the current year. Alternatively, the income from the sale of the last crop is deferred into the following year when very few deductions will exist to offset that income. This can cause a significant tax problem by pushing the farmer into a higher tax bracket and being subject to additional SE tax. It is possible the higher income may exceed the maximum earnings limit for SE tax and not be subject to the 12.4% social security tax.

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CRT Strategy

One option to address the problem is for the farmer to transfer the grain from the last harvest to a CRT. A CRT must be irrevocable and may be either an annuity trust with level annual payments or a unit trust where the annuity is tied to a percentage of the trust assets on an annual basis per IRC §664. With a charitable remainder unitrust (CRUT), it is possible that annual payouts from the trust may increase if the trust assets grow in value. This structure makes it easier to keep pace with inflation. The farmer can be the trustee of the CRT. The IRS provides sample copies of pre-approved annuity trust instruments.[141] Likewise, the IRS has provided sample copies of pre-approved unitrust instruments.[142]

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140. *An Overview of Buy-Sell Arrangements.* Jun. 2020. NFP. [www.nfp.com/media/00bjwgsr/an-overview-of-buy-sell-arrangements.pdf] Accessed on Jul. 30, 2024.

141. See Rev. Procs. 2003-53 through 2003-60, 2003-31 IRB 230.

142. See Rev. Procs. 2005-52 through 2005-59, 2005-34 IRB 326.

Utilizing such a strategy eliminates the SE tax on all of the contributed grain (as compared to the farmer selling the grain to a buyer, such as an elevator). While the farmer would not receive any charitable deduction due to the lack of income tax basis in the contributed grain,[143] the farmer would receive an annuity for life or a term certain not to exceed 20 years. Based on the required structure of the CRT rules, it is likely that at least 10% in present value will pass to a designated charity at the end of the annuity term.[144]

> **Example 8.** Jerry harvests his last crop in 2024. Jerry sells this crop in 2025 for $160,000 and only has $10,000 of deductions to report on his 2025 Schedule F. His SE tax on his reported $150,000 of Schedule F income ($160,000 crop proceeds – $10,000 deductions) is $21,194 ($150,000 Schedule F income × 15.3% SE tax rate × 92.35% percentage of earnings subject to SE tax). If Jerry instead contributes his last crop to a CRT that subsequently sells the crop, Jerry does not owe SE tax, saving him $21,194. This is 13.25% of the crop value ($21,194 SE tax ÷ $160,000 crop proceeds).

A risk with a CRT is the untimely death of the farmer. A strategy to reduce that risk is to buy a life insurance policy to replace the assets in the CRT distributed to the charity and lost to the heir. Likewise, a spouse may be added as a successor income beneficiary to assure that the income stream remains within the family for a longer period of time (as long as the charitable remainder value remains at least 10%).[145] Alternatively, the risk of a premature death could, perhaps, be minimized by setting for the CRT a term certain of 20 years or less so the donor is more likely to outlive the term.

As the farmer collects annuity payments from the CRT over the term prescribed during their lifetime, the income from the last harvest is spread over multiple years instead of one year when the grain would otherwise have been sold. Collecting income over time may allow lower federal tax rates to be applied to the income from the last harvest. Large income amounts in one year can increase Medicare premiums in a later year. Spreading income over multiple years may also increase taxable social security benefits (SSB) in multiple years. These are among the many overall implications to be considered in a comprehensive tax management plan.

The **benefit of a CRT** is that it eliminates SE tax on contributed grain or livestock by a self-employed farmer. It may reduce income tax liability by spreading the income over a timeframe of up to 20 years, and it provides money to a charity at the end of the term. For a farmer that is charitably minded, this could have added value. The **drawbacks** include additional fees for reporting and trust administration, an annuity that locks the farmer in and eliminates flexibility, the inability to self-deal with the CRT, and the possibility of an untimely death of the beneficiary(ies) resulting in lost funds to the heirs with larger amounts passing to the charity. For some, the likelihood that 10% of the amount contributed to the CRT (in present value terms) will pass to a charity is not desirable.

143. Ltr. Rul. 9413020 (Dec. 22, 1993).

144. Most farmers chose the term-certain annuity period to avoid the possibility of an untimely death causing the annuity payments to continue to the decedent's heirs.

145. IRC §664(d)(1)(D).

Cash Balance Plans Strategy

A **cash balance plan** is a qualified retirement plan that allows eligible employees to receive tax-deferred retirement benefits exceeding those of an IRC §401(k) and other retirement plans.[146] In other words, a cash balance plan is a defined benefit retirement plan with an option of a lifetime annuity. The plan specifies the benefit to be received upon retirement in terms of a hypothetical account balance that is based on a formula considering the employee's salary and years of service.[147] The account grows tax-deferred with investment earnings and provides a guaranteed benefit upon retirement payable in a lump sum, regardless of investment performance. The account balance is also portable — the employee (which includes a self-employed farmer) takes it with them if they leave the job. As compared to a traditional defined benefit plan, a cash balance plan provides the employer with more predictable and manageable retirement benefit costs. Large annual tax deductions may be allowed to achieve the plan's objectives; this is a key reason cash balance plans may be attractive to farmers anticipating retirement in a few years.

Note. A traditional defined benefit plan can be converted to a cash balance plan.[148]

With a cash balance plan, the benefit calculation is simpler than for a typical defined contribution benefit plan (traditional pension plan) and, as a result, the administration costs are lower. A cash balance plan is similar to a defined benefit plan in that it provides for employer lump sum funding, subjects the employer to investment risks, and is subject to the same rules as defined benefit plans.[149]

Note. A cash balance plan also requires an actuary to calculate the benefits and funding based on employee demographics and years of service, and is sometimes insured by the Pension Benefit Guarantee Corporation.[150]

However, a cash balance plan differs from a defined benefit plan in that traditional defined benefit plans utilize benefits equal to a set percentage of future earnings that may be 30 or more years in the future. Conversely, a cash balance plan is simply a percentage of current earnings, plus a guaranteed interest rate on account balances.[151]

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146. A cash balance plan satisfies IRC §401(a)(4) if it provides benefit accruals that are nondiscriminatory under the general test for defined benefit plans, or it is nondiscriminatory with respect to an equivalent amount of contributions under the cross-testing rules, or if it meets a special safe harbor for cash balance plans. See Treas. Reg. §1.401(a)(4)-8(c)(3)(i).

147. It is a "hypothetical" account balance because the participant really does not have a separate account. The account balance is merely a bookkeeping entry. The participant's hypothetical account balance is based on hypothetical pay credits (determined as a percentage of salary or compensation) and hypothetical interest credits not exceeding a market rate of return.

148. *Frequently Asked Questions on the Cash Balance Pension Plans Compliance.* U.S. Department of Labor. [www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/faqs/cash-balance-pension-plans-for-employers.pdf] Accessed on Jul. 29, 2024.

149. IRC §411.

150. *Frequently Asked Questions on the Cash Balance Pension Plans Compliance.* U.S. Department of Labor. [www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/faqs/cash-balance-pension-plans-for-employers.pdf] Accessed on Jul. 29, 2024.

151. Ibid.

With a cash balance plan, the employer (which includes a self-employed farmer) credits the participant's account with a set percentage of the participant's annual earnings, plus a credit for interest earned on the participant's cash balance. The employer is responsible for funding limits and requirements, as well as investment risk. Changes in portfolio values do not increase or reduce payment owed to participants at retirement. A cash balance plan is maintained on an individual account basis similar to a defined contribution plan. Contribution amounts increase with the age of the participant. There is no contribution limit because the employer funds the plan to satisfy a specific account balance at the employee's planned retirement date. The maximum amount that can be contributed to a cash balance plan depends on age, earned income from wages, and Schedule F and prior earnings. This is the key provision allowing large annual tax deductions to the employer (also a self-employed farmer).[152]

Note. Cash balance plans also have specific regulatory requirements and limitations that apply for purposes of ensuring the plan's tax-qualified status.

Thus, because of the need to achieve the specific account balance at retirement date, an older employee can contribute more than a younger employee. For persons over age 60, contributions may exceed $300,000 annually. A sole proprietor farmer with a spouse can hire the spouse and include the spouse in the cash balance plan. Contributions to a cash balance plan are deductible. Thus, contributed amounts reduce federal income tax. But, while contributions reduce a sole proprietor's taxable income, they do not reduce SE tax.[153]

Example 9. Jed and Jethro are two brothers who each own 50% of a C corporation engaged in farming. Jed is age 75, Jethro is age 73, and each has been paid $55,000 average wages from the corporation over the past 10 years. There is no other retirement plan currently in place.

A third-party actuarial analysis indicated a deductible contribution of up to $183,000 for each Jed and Jethro into their cash balance plans. If utilized to the maximum level, the corporation could deduct $366,000 each year. This deduction would offset sales of grain and machinery in a retirement transition plan. The amounts in the cash balance plan are taxable to Jed and Jethro when they make withdrawals from the cash balance plan.

The corporation reported the following.

Corporation gross revenue from grain sales	$900,000
Corporation tax deductions before retirement plan contributions	150,000
Corporation taxable income	750,000
Federal income tax liability ($750,000 × 21% tax rate)	157,500

Adding a deductible cash balance plan retirement contribution of $366,000 lowers taxable income to $384,000 ($750,000 original taxable income – $366,000 contribution) and reduces federal income tax liability to $80,640 ($384,000 taxable income × 21% tax rate), a reduction of $76,860 ($157,500 original tax liability – $80,640 revised tax liability with contribution).

Note. Many financial/retirement planners recommend that a cash balance plan be financed for at least three years. Thus, for those that are looking to retire from farming immediately, it might be difficult to spread taxable gain over three years.

152. Ibid.

153. In this respect, the contributions function like a net operating loss or any other type of adjustment to income.

Farmers often defer the income from the sale of crops into the following year and, as a result, maintain an inventory of grain from year-to-year as a tax management strategy to minimize the marginal tax rate. This strategy may allow a farmer to open a cash balance plan and fund it for several years before retirement by a gradual liquidation of grain or livestock inventory. The funding of the plan will be tax-deferred until amounts are withdrawn in later years. Funding may be as a level percentage of pay, a fixed dollar amount, or a hybrid of the two approaches. The approach taken will depend on the farmer's financial goals and cash flow needs.

Example 10. Jesse is 65 years old and wants to retire from active farming. He presently has two years' worth of grain inventory worth $1 million. Jesse also owns 1,000 acres of land that will net him over $250,000 in annual rental income. If he retires and sells the grain in one tax year, the sale will trigger ordinary income and be subject to SE tax. If Jesse lives in a state with a high state income tax, his combined federal and state income tax and SE tax could reach 50%.

For cash flow in retirement, Jesse determines that he does not need income from the sale of the crop because he has $250,000 in annual land rent. He also determines that having the land rent allows him to spread out the grain sales for three years and make deductible contributions into a cash balance plan with those proceeds. The grain sales will trigger SE tax, but the ordinary income that is also recognized will be offset by a deduction for the cash balance plan contribution.

Note. The grain sale income now invested inside the cash balance plan grows tax-free until Jesse takes a distribution. If Jesse does not withdraw any funds from the cash balance plan, the amount in the plan will continue to grow.

A cash balance plan can be combined with a §401(k) plan. A cash balance plan has both minimum and maximum annual limits. For 2024, the lifetime contribution limit per employee is $3.5 million. There is also a limit on compensation as part of the calculation. For 2024, the maximum employee compensation is $345,000.[154] Sole participant plans will max out at $275,000. A primary benefit of a cash balance plan for a farmer nearing retirement is the concept of **age-weighting.** A younger farmer will generally have more years to achieve their desired retirement income goal than will an older farmer. A cash balance plan allows greater contributions as the contributor gets older. Thus, annual contributions will increase with age and higher compensation.[155]

If a farming operation has employees, they may have to be included in the cash balance plan funding. This could result in a higher cost of contributions than anticipated.[156]

Example 11. John and Jeremiah are employees of Mount Hermon Farm where they each make $40,000 annually. John is 36 and Jeremiah is 56 and they each plan to retire at age 62. Mount Hermon Farm would have to make larger contributions for Jeremiah than it would for John for each of them to reach the same retirement income goal at age 62.

Contributions to a cash balance plan must be made for all **eligible** employees (which includes a self-employed farmer).[157] For most farm operations, this would only apply to full-time employees or permanent part-time employees. However, in many situations, the amount required to be contributed is much lower than the amount the farmer can contribute for their benefit. Indeed, it could be the case that a farm operation will need to fund about 5-10% of other employees' annual compensation unless most of these other employees are over age 50. In that situation, the percentage may be significantly higher.

154. IRS Notice 2023-75, 2023-47 IRB 1256.

155. Treas. Reg. §§1.401(a)(4)-1(b)(2)(iii) and 401(a)(4)-8(c)(3)(i).

156. IRC §401(a)(5).

157. Ibid.

Example 12. Sharon is a farmer, age 56, and has a grain inventory of $2 million. She is in her final year of farming and if she were to sell the grain, the sale would be subjected to income tax and SE tax during that final year. Felix, age 27, is Sharon's employee. Felix has a wage of $47,000 annually.

If Sharon uses a cash balance plan to defer the tax on the $2 million, she could fully fund the cash balance plan over six years with annual contributions of approximately $285,000. About $10,000 is required for Felix, with the remainder being credited to her account. When Sharon turns age 62, she will have about $1.8–2.0 million in the plan and none of it is subject to a required minimum distribution (RMD) until she turns 75.[158] However, Sharon will be subject to SE tax on the six years of grain sales to fund the full cash balance plan contributions — approximately $230,000 of SE tax over the six years.

Caution. Sharon should consider the risks associated with holding her grain for six years before selling.

Comparison of the Strategies

Both strategies (CRT and cash balance plan) have their own benefits and detriments as summarized in the following table.

	CRT	Cash Balance Plan
Advantages	• Eliminates SE tax on contributed grain or livestock. • Reduces income tax rates by spreading income over the term of the annuity (potentially up to 20 years). • Provides funds to a charity at the end of the term.	• A farmer aged 55 or older can make large contributions to reduce taxable income. • Most farmers are allowed to fully offset ordinary income or wages with contributions. • Defers income tax to age 73/75.
Disadvantages	• 10% of the funds in present value will likely pass to a charity. • The costs of administration and reporting. • The farmer is locked into the annuity with no flexibility. • No self-dealing is permitted. • An untimely death of the beneficiary(ies) can result in lost funds to heirs and remaining funds to charity. • Involves the element of a loss of control.	• The taxpayer is subject to full SE tax on earned income.[159] • Higher administrative costs for an actuary and Form 5500, *Annual Return/Report of Employee Benefit Plan,* filing requirements. • Must contribute for full-time and permanent part-time employees. • The plan must be maintained for five to ten years. • Creates larger RMDs beginning at age 73/75.[160]

158. Per *SECURE 2.0 Act of 2022,* PL 117-328, §107, the RMD for those born in 1960 or later is age 75. Sharon is age 56 in 2024, making her born in 1968 with an RMD of 75.

159. It is uncertain whether commodity wages qualify for cash balance funding. Also, it is likely that the SE cost will be close to the amount the passes to charity with a CRT.

160. The taxpayer could possibly be in the highest tax bracket at that time, or the larger RMDs may result in large Medicare income-related monthly adjustment amount (IRMAA) adjustments.

Practitioner Planning Tip

There is no one-size-fits-all strategy, and practitioners should analyze their clients' particular situation to help them select the best strategy.

INSTALLMENT SALES

Note. For more information on installment sales, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 6: Installment Sales.

A common method for transferring a business interest to someone (such as a parent to a child in the case of a closely held business interest) is via a sale of that interest.[161] As opposed to an outright sale of the interest, a parent could structure the sale of the business interest as an **installment sale** — defined as the sale of an asset with at least one payment received after the tax year of sale.[162] Income tax and estate planning considerations are often the reasons for transferring interests in a business over time on an installment basis. For instance, an installment sale causes capital gains to be recognized when payments are made over the installment period which might keep the seller in lower tax brackets than would an outright sale. Additionally, it could minimize the potential for spikes in taxable income which, in turn, could reduce exposure to additional taxes, such as the NIIT.[163] The senior generation of a family business, for instance, may desire to transition out of ownership control, but would like the cash flow of funds from the sale of their business interests to be received over time rather than in a lump-sum. In addition, an installment sale can be used in an estate plan to "freeze" the value of an estate (typically that of a parent),[164] and simultaneously shift future appreciation in asset value caused by inflation or improvements to the next generation successor-operator.

Note. As an option, the sale of the business interest could be to an **irrevocable grantor trust** where the seller (typically a parent) is treated as the owner of the trust for income tax purposes — known as an **intentionally defective grantor trust (IDGT).** In general, the funding of the trust must be done via a seed gift of at least 10% of the FMV of the property sold to the trust. The seller receives a note in exchange with a face amount equal to the value of the assets with a minimum amount of interest charged and with the note secured by the property. The sale to the trust does not trigger capital gain tax and if the note is for adequate consideration, gift tax is not triggered. The value of the business interest sold to the trust is "frozen" in the form of the note. The cash flow from the interest (and, perhaps, appreciation in the interest's value) is structured to cover the loan with the balance passing to the trust beneficiaries.

For more information about IDGTs, see the 2016 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Wealth Accumulation and Preservation. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

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161. A sale, while effective for transferring a business interest to the next generation as part of an estate/transition plan, generates capital gain when the sale of a capital asset is involved.

162. IRC §453(b).

163. IRC §1411.

164. The "freeze" occurs by exchanging the interest for cash or a promissory note that cannot appreciate in value.

Structured as an installment sale with an appropriate rate of interest, the transaction does not constitute a gift, and can provide a stream of income for the parents (as the sellers). In addition, if the value of the assets subject to the installment sale drop in value, the transaction can be renegotiated and the purchase price decreased while still maintaining installment sale tax treatment.

A part of each principal payment is treated as interest rather than sales price if interest of less than the prescribed "test rate" is specified.[165] Where the amount of seller financing in a transaction is $7,098,600 or less for 2024,[166] the test rate is the **lesser** of 9% or 100% of the applicable federal rate (AFR). When the amount of seller financing is more than $7,098,600 for 2024, the test rate is 100% of the AFR.[167] The threshold amount is indexed for inflation and the AFR is determined on a monthly basis.

Note. The AFR is based on the average yield on federal debt obligations of similar maturity. The short-term rate is for obligations with a term not more than three years, the mid-term rate is for obligations with a term over three years but not more than nine years and the long-term rate is for a term of more than nine years. The federal rate used is the lowest of the rates in effect as of the first day on which there is a binding contract in writing for the sale or exchange, the rate for the preceding month or the rate for the second preceding month. The IRS issues monthly tables. For August 2024, for example, the long-term AFR is 4.52%.[168]

In general, both parties are required to account for the interest in seller-financed transactions under the accrual method of accounting. However, if the amount of seller financing is $5,070,500 or less for 2024,[169] both parties may elect to account for interest under the cash method of accounting.[170]

Installment Reporting of Gain

In general, gain or loss must be recognized at the time of sale. However, under the installment method, a seller can defer tax and recognize gain for any particular tax year in proportion to the amount of installments received.[171] This allows the seller to spread the income tax liability over the entire term. Installment contracts are also beneficial because the periodic payments can be available to the seller for retirement income, a security interest may be retained in the property, and the buyer has control and beneficial enjoyment of the property.

Caution. If the seller outlives the term of the contract, cash flow problems could result if the payments are used for living expenses. Thus, the term of the contract (and associated note) should not exceed the seller's life expectancy. A backup plan should be in place to protect against the possibility of a premature death.

165. IRC §483.

166. Rev. Proc. 2023-34, 2023-48 IRB 1287.

167. The 9% test rate is not available for new property that would have been eligible for the investment tax credit, and any seller financing provided in connection with a sale-lease-back transaction must use a test rate of 110% of the AFR.

168. Rev. Rul. 2024-15, 2024-32 IRB 340.

169. Rev. Proc. 2023-34, 2023-48 IRB 1287.

170. IRC §1274A(b); The figure is indexed for inflation, and the election to report interest on the cash method of accounting is unavailable to dealers or those on the accrual method of accounting.

171. IRC §453.

Installment reporting of gain is automatic for eligible property.[172] An election not to have installment reporting apply is made by reporting the income from the sale on or before the due date (including extensions of time) for filing the income tax return for the year in which the sale occurs.[173] Once an election is made, it can only be revoked with the consent of the IRS. In addition, installment reporting only applies to gain, and not to loss, upon sale of real property.

Note. Not all sales of property are eligible for installment sale treatment. One common property not eligible is the sale of farm equipment that includes the recapture of depreciation.[174]

When real property is sold on an installment basis, part of each payment received represents gain and part represents a nontaxable return of the taxpayer's basis in the property. The amount of principal reported as income for any year is determined by the **gross profit percentage,** which is based upon the gross profit on the entire transaction, the basis of the property, and the total contract price.[175] **Gross profit** is the selling price less the adjusted tax basis.[176] The selling price is computed without a reduction for any existing mortgage and/or selling expenses. The **total contract price** is the amount to be paid by the buyer and does not include a mortgage except to the extent the mortgage exceeds the income tax basis.[177] The remaining amount of each principal payment is a **nontaxable return of basis.** Interest received is taxable as ordinary income and may be subject to the NIIT even if business property is being sold.

The reporting of gain from an installment sale of real property involves a 4-step process, as follows.[178]

Step 1. Calculate gross profit (selling price – seller's adjusted basis in the property). In making this computation, expenses of sale are added to the basis of the property.

Step 2. Calculate total contract price (amount the buyer pays – indebtedness). The indebtedness must be **qualifying indebtedness** that is functionally related to the property. Debt incident to the sale, such as legal fees, does not qualify.

Step 3. Calculate gross profit percentage (gross profit ÷ total contract price).

Step 4. Calculate amount of gain to be reported for the year (each payment received × gross profit percentage).

Example 13. Wilbur Jones is retiring from farming, and has no heirs interested in continuing the operation. As a result, Wilbur decides to sell his farm to Tom Tiller in 2024 for $1,325,000. Wilbur sells the farm on an installment basis and agrees to take annual payments beginning in 2024 of $66,250 for 20 years with no down payment. Wilbur's basis in the farm is $360,000, and he owns the farm debt-free. The expenses of the sale are $26,500.

The computational process for reporting gain is as follows.

Step 1. Calculate gross profit.

Selling price	$1,325,000
Less: basis	(360,000)
Less: expenses of sale	(26,500)
Gross profit	$ 938,500

172. IRC §453(d)(1).

173. IRC §453(d)(2).

174. IRC §453(1)(2)(A); See also *Thom v. U.S.,* 283 F.3d 939 (8th Cir. 2002).

175. Interest (actual or imputed) is taxed as ordinary income.

176. Treas. Reg. §1.453-1(b)(2)(v).

177. Treas. Reg. §1.453-1(b)(2)(iii).

178. IRS Pub. 537, *Installment Sales*.

Step 2. Calculate total contract price.

Selling price	$1,325,000
Less: qualifying indebtedness	(0)
Total contract price	$1,325,000

Step 3. Calculate gross profit percentage.

$$\textbf{Gross profit percentage} = \frac{\textbf{Gross profit}}{\textbf{Total contract price}}$$
$$= \frac{\$938{,}500}{\$1{,}325{,}000}$$
$$= 70.83\%$$

Step 4. Calculate amount of each payment received reportable as gain.

Amount received in 2024	$66,250	$66,250
Gross profit percentage	× 70.83%	
	$46,925	(46,925)
Amount representing nontaxable return of basis		$19,325

Depreciation[179]

The buyer may claim depreciation on qualifying property from the date of possession. Recaptured depreciation previously claimed by the seller is fully treated as taxable income to the seller in the year of sale. Depreciation recapture is involved when gain is realized on the disposition of depreciable property. The recapture of depreciation is instantaneous with no eligibility for deferral of income by installment sale. However, taxpayers can defer recognition of gain arising from unrecaptured IRC §1250 gain.[180]

Example 14. Hammond Beans acquired a tract of farmland and associated buildings on an installment basis in 2012. The purchase price was $1 million. Hammond sells the tract in 2024 for $1 million. During Hammond's period of ownership, Hammond took $400,000 of depreciation on the buildings subject to §1250 recapture ($100,000 in excess of what straight-line depreciation would have been).

Thus, upon the sale of the land and buildings in 2024, and even though the sale price did not exceed the purchase price, Hammond recognizes $400,000 of gain. Of that amount, $100,000 is reportable as depreciation recapture and $300,000 is unrecaptured §1250 gain, subject to a maximum tax rate of 25%. The unrecaptured §1250 gain is eligible for installment sale treatment. **The $100,000 of depreciation recapture is reported in the year of sale even if Hammond receives nothing under the contract in the year of sale.**

Example 15. Josh is retiring from farming and sells his machinery in 2024 to Jacob, his nephew, for $850,000. Jacob will make annual payments of $85,000 plus interest to be paid over 10 years beginning in 2025. Josh paid $1.2 million for the equipment and has fully depreciated that amount, leaving an adjusted tax basis of $0. **Due to the depreciation recapture rules, Josh must recognize the full $850,000 as taxable income in 2024 and only interest will be taxable in future years.**

179. Ibid.

180. IRC §453(i)(1)(B).

Practitioner Planning Tip

Because depreciation recapture is ineligible in an installment sale, taxpayers may not have cash available for year of sale taxes. Practitioners with clients nearing retirement who are planning on selling equipment and machinery need to have planning discussions before clients finalize transactions.

Payments in the year of sale include a down payment or other payment in a prior year. The **year of sale** is generally the year in which the benefits and burdens of ownership pass from seller to buyer. Usually this involves the transfer of possession unless title passes before any other transfer of benefit, in which case the year of title passage is the year of sale. If the seller's indebtedness taken over by the buyer exceeds the income tax basis of the property, the excess is considered a payment in the year of sale.[181]

Possible Gift Tax Treatment

When farmland is sold under an installment contract, it is often done to aid the farmer-buyer as an alternative to more traditional debt financing. Accordingly, the sale might be for less than FMV — known as a **bargain sale.**[182] In such a situation, the IRS could argue that the excess of FMV over the amount paid constitutes a gift. Also, if the buyer experiences financial trouble and cannot make the payments on the installment obligation and the seller forgives some of the principal on the contract, tax issues result. The same is true if the principal is forgiven as a means to pass wealth to the buyer as a family member and next generation farmer.

Given that the 2024 level of the present interest annual exclusion for gift tax purposes is $18,000,[183] an installment sale transaction could be established whereby farm assets could be conveyed to a child, for example, for an $18,000 principal amount interest-bearing note, payable semi-annually. This provides an income stream to the parents and does not trigger any gift tax.[184] But, if the parents desire to make a gift to the child, the payments could be forgiven as they become due. In that situation, it might be possible to discount the gift (for lack of control and lack of marketability, etc.) below the face value of the installment obligation. Also, if a gift is made within three years of death, any gift tax that the decedent (or the estate) pays on the gift is pulled back into the estate.[185] In addition, in an estate, an installment obligation is income in respect of a decedent (IRD).[186] It is not an item of property. That means that there is no basis step-up in accordance with IRC §1014 in the hands of the recipient of the obligation.[187]

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181. IRS Pub. 537, *Installment Sales*.

182. To deflect an IRS challenge, it is possible to use a "formula clause" that expresses the amount of the property being sold as a formula. See, e.g., *Wandry v. Comm'r*, TC Memo 2012-88 (Mar. 26, 2012), *nonacq.* AOD 2012-46 (Nov. 13, 2012).

183. Rev. Proc. 2023-24, 2023-48 IRB 1287; IRC §2503(a)(1), as adjusted for inflation.

184. This is because installment sales are not within the scope of IRC §2701.

185. IRC §2035.

186. IRC §691(a)(2).

187. IRC §691(a)(4).

In *Deal v. Comm'r,*[188] a mother bought a tract of land at auction and transferred it in trust to her three sons-in-law for the benefit of her daughters. Simultaneously, the daughters executed non-interest-bearing demand notes payable to their mother. The notes were purportedly payment for remainder interests in the land. The mother canceled the notes in portions over the next four years. For the tax year in question, the mother filed a federal gift tax return, but did not report the value of the canceled notes on the basis that the notes the daughters gave made the transaction a purchase rather than a gift. The IRS disagreed, and the Tax Court agreed with the IRS. The Tax Court determined that the notes that the daughters executed were not really intended to be enforced and were not consideration for their mother's transfers. Instead, the transaction constituted a plan with donative intent to forgive payments. That meant that the transfers were gifts to the daughters. Even though the amount of the gifts was under the present interest annual exclusion amount each year, they were gifts of **future interests** such that the exclusion did not apply and the full value of the gifts was taxable.

In *Haygood v. Comm'r,*[189] the Tax Court upheld an arrangement where the parents transferred property to their children and took back vendor's lien (conceptually the same as a contractor's lien) notes which they then forgave as the notes became due. Each note was secured by a deed of trust or mortgage on the properties transferred. The Tax Court believed such facts contributed to the transaction appearing as a sale, with the periodic forgiveness of the payments under the obligation then constituting gifts.

> **Observation.** In *Deal*, the Tax Court noted that the property was transferred to a trust and **on the same day** the daughters (instead of the trust) gave notes to the mother. In addition, the notes did not bear interest and were unsecured. In *Haygood*, by contrast, the notes were secured, and the amount of the gift at the time of the initial transfer was reduced by the face value of the notes.

The Tax Court ruled likewise in *Estate of Kelley v. Comm'r.*[190] The case involved the transfer of a remainder interest in property and the notes received (non-interest-bearing vendor's lien notes) were secured by valid vendor's liens and constituted valuable consideration in return for the transfer of the property. The value of the transferred interests was reported as taxable gifts to the extent the value exceeded the face amount of the notes. The notes were forgiven as they became due. The IRS claimed that the notes lacked economic substance and were just a "façade for the principal purposes of tax avoidance."

The Tax Court disagreed with the IRS position. The Tax Court noted that the vendor's liens continued in effect as long as the balance was due on the notes. In addition, before forgiveness, the transferors could have demanded payment and could have foreclosed if there was a default. Also, the notes were subject to sale or assignment of any unpaid balance and the assignee could have enforced the liens. As a result, the transaction was upheld as a sale.

In Rev. Rul. 77-299,[191] the IRS said that an installment sale of land to grandchildren where the annual payments were forgiven constituted a gift of the full amount of the land in the year the parties entered into the transaction. The IRS came to this conclusion because the grandparent had been gifting property to his grandchildren in prior years and because the grandchildren did not have any other source of income. The courts, however, do not tend to agree with the IRS's position, particularly if the notes involved are legally enforceable, subject to sale to third parties or are assignable, and the property involved is subject to foreclosure if the buyer defaults.[192]

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188. *Deal v. Comm'r*, 29 TC 730 (1958).

189. *Haygood v. Comm'r,* 42 TC 936 (1964).

190. *Estate of Kelley,* 63 TC 321 (1974).

191. Rev. Rul. 77-299, 1977-2 CB 343.

192. See, e.g., *Estate of Kelley v. Comm'r,* 63 TC 321 (1974); *Haygood v. Comm'r*, 42 TC 936 (1964); *Hudspeth v. Comm'r,* 509 F.2d 1224 (9th Cir. 1975).

The IRS reiterated its position taken in Rev. Rul. 77-299 in Field Service Advice (FSA) 1999-837.[193] In the FSA, two estates held farm real estate. The executors agreed to a partition and an IRC §1031 exchange of the land. After the exchange, the heirs made up the difference in value of the property they received by executing non-interest-bearing promissory notes payable to one of the estates. The executors sought a court order approving annual gifts of property to the heirs. They received that order which also provided that the notes represented valid, enforceable debt. The notes were not paid and gift tax returns were not filed. Tax returns did not report the annual cancelation of the notes. The IRS determined that a completed gift occurred at the time of the exchange and that each heir could claim a single present interest annual exclusion ($10,000 at the time). The IRS determined that the entire transaction was a prearranged plan to make a loan and have it forgiven — a sham transaction.[194]

Note. From a planning standpoint, the IRS's position makes it clear that loan transactions must be structured carefully in instances where the donor intends to forgive note payments. Written loan documents secured by notes where the borrower can and does make some payments may help minimize "sham" treatment.

It is also possible that a gift may occur on an installment sale of land if the interest rate is below a market rate of interest. The IRS, U.S. Tax Court, the Eighth and Tenth Circuit Courts of Appeals, and the U.S. District Court for the Northern District of New York agree that the use of an interest rate in an installment sale other than the market rate of interest results in a gift of the present value of the difference in interest rates (i.e., the market rate of interest and the interest actually charged).[195] For sales of land between family members, to the extent that the sales price does not exceed $500,000 during a calendar year, the minimum interest rate is the lower of 6% compounded semi-annually and the AFR.[196]

Observation. If an installment sale is an arm's length transaction where the parents are not legally obligated to forgive payments or make cash gifts to enable the buyer (child(ren)) to make the payments, the installment sale should be respected and would not trigger a gift in the year in which the transaction is entered. This is particularly the case if the value of the business interest involved is established with an appraisal, the parents actually receive payments in the early years of the installment sale, and an appropriate market rate of interest is utilized.

Sale-Leaseback

Parents who are not ready to retire from farming or ranching may consider a sale-leaseback transaction. Under this structure, the parents sell the property to their children and then lease it back. While this type of transaction results in the parents recognizing gain, that gain can at least be partially offset by a deduction for rent expense. In addition, the rental payment that the parents make to the children will help the children make the payments. A bona fide sale-leaseback transaction results in the children deducting interest on the installment obligation to the extent they use the rental payments they receive from their parents to repay the mortgage on the property purchased under the installment sale. However, no interest deduction is allowed for annual payments attributable to cash gifts. The sale-leaseback transaction works if ownership is completely transferred to the children, and the children have a non-contingent obligation to pay.[197]

193. Rev. Rul. 77-299, 1977-2 CB 343; FSA 1999-837 (Jun. 18, 1999).

194. See also Ltr. Rul. 200603002 (Oct. 24, 2005).

195. See, e.g., Ltr. Rul. 8804002, Sep. 3, 1987; *Frazee v. Comm'r*, 98 TC 554 (1992); *Krabbenhoft v. Comm'r*, 939 F.2d 529 (8th Cir. 1991), *cert. denied,* 502 U.S. 1072 (1992); *Schusterman v. Comm'r*, 63 F.3d 986 (10th Cir. 1995), *cert. denied,* 116 S. Ct. 1823 (1996); *Lundquist v. U.S.*, 99-1 U.S. Tax Cas. (CCH) ¶60,336 (N.D. N.Y. 1999). The 7th Circuit Court of Appeals disagrees, however. *Ballard v. Comm'r,* 854 F.2d 185 (7th Cir. 1988).

196. IRC §483(e). Under IRC §483(e)(2), spouses of children are not "members of the family."

197. See, e.g., *Hudspeth v. Comm'r,* 509 F.2d 1224 (9th Cir. 1975)*; Stiebling v. Comm'r,* TC Memo 1994-233 (May 26, 1994), *aff'd* without published opinion, 113 F.3d 1242 (9th Cir. 1997).

C Corporation. For a sale-leaseback transaction involving a C corporation, it is imperative that the C corporation has sufficient earnings and profits. This means that distributions from the C corporation that a sole shareholder receives from a third party are not constructive dividends under IRC §316.[198]

IRC §1031 Exchange. Generally, an exchange of property for other property is treated as a sale. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a like-kind to be held either for productive use in a business or for investment.[199] The new property is treated as a continuation of the original property. Gain is recognized, however, to the extent of any **boot** (unlike property) received in the exchange.

There are four basic requirements to achieving tax-deferred treatment under §1031.[200]

1. There must be an **exchange** of property rather than a sale.
2. The property exchanged and the property received must be **like-kind** to the property relinquished.
3. The property exchanged and the property received must both be **held for productive use** in a trade or business or for investment.
4. The exchange of properties must be simultaneous, or the replacement property must be identified within 45 days of the exchange. Identified property must be received within 180 days of the identification or the due date of the transferor's return (including extensions), if earlier.[201]

If an exchange cannot be completed during the allotted timeframe, the funds held by a qualified intermediary (QI) are released to the seller, triggering taxation in the year of sale and defeating the purpose of the exchange.[202] However, language may be included in the sales contract directing the QI to send the funds to an assignment company which will then disperse the payments to the seller over a predetermined period of time through an **assignment trust.** This allows the seller to defer the income and associated taxes under the installment method by converting the transaction into one governed by the installment sale rules of IRC §453.

A sale-leaseback transaction may also be combined with a §1031 exchange. For example, in *Estate of Bartell v. Comm'r*,[203] the Tax Court upheld a non-safe-harbor reverse exchange that involved a sale-leaseback transaction. In the late 1990s, Bartell Drug Co. (Bartell) began utilizing §1031 exchanges in an attempt to relocate its stores as part of a change in its business model due to the growing obsolescence of its retail stores and a changing market structure. In August 2000, Bartell, an S corporation, arranged to buy another property (replacement property) to build a new drugstore. A QI facilitated the exchange.

An affiliate of the QI took title to the replacement property. The agreement specified that the affiliate was to lease the replacement property back to Bartell until Bartell acquired ownership upon completion of the exchange. Simultaneously, Bartell was in the process of finding a buyer for the property to be relinquished. Eventually a buyer was found, and the transaction was structured as a sale-leaseback with the buyer agreeing to cooperate if Bartell sold the property as part of a §1031 exchange.

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198. See, e.g., *Fabian v. Comm'r,* TC Memo 2022-94 (Sep. 13, 2022).

199. This rule does not cover stock in trade, or other property held primarily for sale, such as stocks or bonds.

200. IRC §1031(a)(1).

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

202. IRC §1031(a)(3)(B).

203. *Estate of Bartell v. Comm'r,* 147 TC 140 (2016).

In late 2001, Bartell and the QI executed a §1031 exchange. The IRS denied §1031 treatment on the basis that Bartell owned the replacement property long before it had disposed of the relinquished property,[204] and that the QI did not have any of the benefits and burdens of ownership. The Tax Court held that a third-party facilitator (the QI) took title to the replacement property and did not need to assume the benefits and burdens of ownership in the replacement property under §1031. Thus, the transaction qualified for like-kind exchange treatment.[205]

> **Note.**The transaction at issue in *Bartell* occurred before the issuance of Rev. Proc. 2000-37[206] which provides a safe harbor for placing replacement or relinquished property with a QI. Under the safe harbor, the QI cannot hold the property for more than 180 days to be considered the owner of the property, regardless of which party bears the burdens and benefits of ownership.

Related-Party Issues

For sales between closely related parties,[207] disposition of the property by the purchaser within two years of the original transaction may result in taxable gain to the original seller. The following exceptions may apply.

1. Transfers caused by involuntary conversion
2. Transfers after the death of the installment seller or purchaser
3. Sale or exchange of stock to the issuing corporation
4. Transfers where it is established to the satisfaction of the IRS that the disposition did not have, as one of its principal purposes, income tax avoidance[208]

Thus, if an exception does not apply, when a related party resells the property within two years of the original sale, gain is accelerated to the original seller.[209]

> **Note.** A popular technique with some farm families is for a parent to transfer an installment contract to a child in exchange for annuity payments. This transaction is a taxable disposition because no provision in either §453 or §453B provides an exception from taxability.
>
> Alternatively, a donor may recognize gain or loss on the gift of the installment contract. The donor's gain is equal to the amount that the FMV of the installment contract (at the time of the gift) exceeds the donor's basis.[210] The donee's tax basis in the contract is the FMV of the installment contract at the time of the gift.

For installment sales of depreciable property between related persons (limited to entities), the deferred payments are deemed received in the taxable year of sale.[211] Family members are **not** included in the definition of **related parties.** An exception is provided if income tax avoidance is not a principal purpose.

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204. The IRS based its position on *DeCleene v. Comm'r*, 115 TC 457 (2000).

205. The IRS has issued a nonacquiescence to the Tax Court's decision, AOD 201706 (Aug. 6, 2017). Thus, the IRS will continue to scrutinize arrangements that fall outside the safe harbor to determine whether the taxpayer has received the benefits and burdens of ownership before the transfer of legal title to the property.

206. Rev. Proc. 2000-37, 2000-2 CB 308.

207. For this purpose, "related party" is defined by the rules contained in IRC §267(b) per IRC §453(f)(1)(B).

208. IRC §§453(e)(6)–(7).

209. Disposition after the death of the seller or buyer to the original truncation is not treated as a second disposition per IRC §§453(g) and 1239(b). The same is likely true when there is a death of a joint tenant with respect to jointly owned property.

210. IRC §453B(a)(2).

211. IRC §§453(g) and 1239(b).

When depreciable property is sold to a related party, ordinary income results.[212] In addition, the seller cannot use the installment method to report the income unless a principal purpose of the sale was something other than the avoidance of federal income tax.[213] A related party for this purpose is defined under IRC §1239(b).

Practitioner Planning Tip

Any installment sale contract should contain language that bars any disposition by the buyer within two years of the original sale unless the original seller consents. The same can be said with respect to pledging the property. In that instance, the original buyer should continue to bear any risk of loss associated with the property.

Principal Forgiveness

Cancelation of an installment obligation is treated as a taxable disposition of the obligation by the holder.[214] The amount of the gain is the difference between the FMV of the obligation and its basis, if the parties are not related.[215] Therefore, if the seller forgives or cancels the obligation to pay amounts due, the result is the same as a disposition of the obligation. If the parties are related, the gain is the difference between the face amount and the basis of the obligation.[216] FMV of the obligation is treated as not less than its face value. The IRS has ruled that cancelation of principal in a debt restructuring involving an installment sales contract does not result in income tax consequences to the seller.[217]

Other Dispositions

Sale, gift, or other disposition or satisfaction of an installment obligation results in recognition of gain.[218] In essence, almost anything the seller does triggers tax liability. A disposition or satisfaction of an installment obligation at other than face value results in recognized gain to the taxpayer, equalling the difference between the amount realized and the income tax basis of the obligation.[219] If the disposition takes the form of a "distribution, transmission, or disposition otherwise than by sale or exchange," the amount included in income is the difference between the FMV of the obligation and its income tax basis.[220] If related parties (in accordance with IRC §267(b)) are involved, the FMV of the obligation is considered to be not less than its full face value.[221]

212. IRC §1239.
213. IRC §453(g)(2); See, e.g., Ltr. Rul. 9926045 (Apr. 2, 1999).
214. IRC §453B(f)(1).
215. IRC §453B(a)(2).
216. IRC §453B(f).
217. Ltr. Rul. 8739045 (Jun. 30, 1987).
218. IRC §453B(a). The privilege of income deferral by installment reporting is generally personal to the party electing the installment method and does not outlast the period during which the obligation is held.
219. IRC §453B(a)(1).
220. IRC §453B(a)(2).
221. IRC §453B(f)(2).

There are two exceptions where transfer does not require gain recognition.[222]

1. **Disposition on account of death.** In the event the seller dies within the term of the contract, the tax is not immediately due, but the installment contract does not receive a new basis. Payments received after death are treated as IRD and the recipient reports the income in the same manner as if the decedent were still living. Disposition of an installment obligation to the obligor after death of the seller results in taxable gain for the deceased seller's estate to the extent of the obligor's ownership share. The impact of death on an installment sale is discussed next.

2. **Transfers by one spouse to another or a transfer between ex-spouses because of divorce.** In this case, the transferee is taxed on the installment obligation just as the transferor would have been taxed.[223]

Impact of Death

If the seller dies before the contract terminates, the value of the outstanding note will be included in the decedent's estate as of the date of death.[224] The cancelation of the remaining installments at death produces taxable gain.[225] In *Estate of Frane v. Comm'r*,[226] the Tax Court decided, based on §453B(f), that the installment obligations of the decedent's children were nullified where the decedent (transferor) died before two of the four could complete their payments. That meant that the deferred profit on the installment obligations had to be reflected on the **decedent's final tax return.** But, if cancelation is a result of a provision in the decedent's will, the canceled debt produces gain that is included in the **estate's gross income.**[227] In that instance, the obligor (the party under obligation to make payment) has no income to report.

If an installment obligation is transferred on account of death to someone **other than the obligor,** the transfer is not a disposition. Any unreported gain on the installment obligation is not treated as gross income to the decedent and no income is reported on the decedent's return due to the transfer. The party receiving the installment obligation as a result of the seller's death is taxed on the installment payments in the same manner as the seller would have been had the seller lived to receive the payments.

Upon the holder's death, the installment obligation is IRD.[228] This results in no basis adjustment at death. IRC §691(a)(4) states the following.

> *In the case of an installment obligation reportable by the decedent on the installment method under section 453, if such obligation is acquired by the decedent's estate from the decedent or by any person by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent —*
>
> > *(A) an amount equal to the excess of the face amount of such obligation over the basis of the obligation in the hands of the decedent (determined under section 453B) shall… be considered as an item of gross income in respect of the decedent; and*
> >
> > *(B) such obligation shall… be considered a right to receive an item of gross income in respect of the decedent, but the amount includible in gross income… shall be reduced by an amount equal to the basis of the obligation in the hands of the decedent (determined under section 453B).*

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222. IRS Pub. 537, *Installment Sales*.

223. IRC §453B(g). One way to address this issue is for the seller to receive a self-canceling installment note (SCIN) in exchange for the asset(s) being sold. With a SCIN, the remaining note principal is canceled if the parent dies before the end of the note term. See, e.g., *Estate of Costanza v. Comm'r,* 320 F.3d 595 (6th Cir. 2003).

224. Thus, the FMV of the note as of the date of the decedent's death (unpaid principal plus accrued interest) is potentially subject to federal (and, perhaps, state) estate tax.

225. See, e.g., *Estate of Frane v. Comm'r*, 98 TC 341 (1992), *aff'd in part rev'd in part*, 998 F.2d 567 (8th Cir. 1993).

226. Ibid.

227. Ltr. Rul. 9108027 (Nov. 26, 1990).

228. IRC §691.

However, the disposition (sale) at death of the installment contract to the obligor is a taxable disposition.[229] Similarly, if the cancelation is triggered by the holder's death, the cancelation is treated as a transfer by the decedent's estate (or trust if the installment obligation is held by a trust).[230]

Modification of Contract Terms

If the holder of the obligation simply reduces the selling price but does not cancel the balance that the obligor owes, it is not a disposition.[231] Similarly, the modification of an installment obligation by changing the payment terms (such as reducing the purchase price and interest rate, and deferring or increasing the payment dates) is not a disposition of the installment obligation. The gross profit percentage must be recomputed and applied to subsequent payments. Also, where the original installment note was replaced, the substitution of a new promissory note without any other changes is not a disposition of the original note.[232]

> **Note.** There is also no disposition if the buyer under the installment obligation sells the property to a third party and the holder allows the third party to assume the original obligor's obligation. That is the case even if the third party pays a higher rate of interest than the original obligor.[233]

Unless agricultural property is involved, the tax consequences are also unfavorable if the seller takes the contract to a lender and pledges the contract on a new loan.[234] In that event, the entire amount of the loan proceeds is treated as a payment on the contract. This is a tremendous blow to a seller trying to dispose of an installment obligation.[235] Since December 17, 1987, pledging of installment obligations has resulted in the net proceeds of the secured indebtedness being treated as a payment received for installment obligations above $150,000, except for personal-use property and farm property.[236]

Structured Installment Sale

A **structured installment sale** is a variation of the standard installment sale technique. The concept involves the traditional installment sale with the buyer then assigning the buyer's obligation to an assignment company. The buyer transfers the discounted present value of the payment stream due under the installment sale agreement in a lump sum to the company in return for the company's assumption of the buyer's payment obligation. A life insurance company issues an annuity contract to the assignment company, which then becomes the source of the installment payments to the seller. The life insurance company then guarantees it will make all periodic payments due upon notice by the assignment company of the company being unable to make the required installment payments.[237]

229. IRC §§691(a)(4)-(5).

230. IRC §691(a)(5)(A).

231. Ltr. Rul. 8739045 (Jun. 30, 1987).

232. See, e.g., Ltr. Ruls. 201144005 (Aug. 2, 2011) and 201248006 (Aug. 30, 2012).

233. Ibid.

234. CCA 20123401F (Jul. 18, 2012).

235. However, the result is different if the interest rates and maturity date differ, and the taxpayer does not part with a substantial portion of the ownership rights in the obligation.

236. IRC §453A(d).

237. *An Introduction to Structured Installment Sales.* Finn, Don. Dec. 2021. The CPA Journal. [cpajournal.com/2021/12/31/an-introduction-to-structured-installment-sales]. Accessed on Jul. 29, 2024.

The transaction qualifies for installment reporting. In addition, the assignment does not accelerate income because it does not alter the original obligation.[238] Likewise, the buyer's transfer of the obligation to make periodic payments to the assignment company is not a disposition.[239] A disposition does not occur if the seller possesses substantially the same rights that the seller received in the original transaction.[240]

> **Observation.**The perceived benefit of a structured installment sale is that the seller ends up as the beneficiary of an annuity that is backed by an insurance company.

IRC §721 Exchange[241]

Another mechanism for deferring capital gain tax that is conceptually similar to an installment sale is a §721 exchange. This transaction involves an exchange of real estate for interest in an operating partnership.

> **Note.** While the concept has been widely used for commercial real estate, the concept also applies to farmland.

Under §721, property that is contributed to a partnership in exchange for an interest in the partnership does not trigger gain or loss.[242] The partnership maintains ownership of the farmland and distributes the income from the portfolio of investment properties that the partnership holds.[243] The partners retain the right to sell, gift, bequeath, or retain their interest. Tax is deferred until the farmland owner redeems or sells the interest, which can be planned to occur when the taxpayer is in a lower tax bracket.

An estate planning benefit of this technique is that the interest can be divided more easily than can fractional interest in real estate and, if necessary, be more easily liquidated upon the owner's death.

> **Caution.** It is possible that the partnership would decide to liquidate some of its holdings, which could affect all partners. The partnership retains the right to return capital to the investor instead of reinvesting it in a new property. Such a return of capital is a taxable event and could occur in a year that is not tax efficient for the partners. In addition, such distributions are taxed as long-term capital gains.

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238. See, e.g., *Caldwell v. U. S.*, 114 F.2d 995 (3d Cir. 1940). The assignment is neither a disposition nor a deemed disposition under IRC §453(d). The buyer created the debt obligation, and the assignment company does not become directly contractually liable to the seller.

239. See, e.g., *Cunningham v. Comm'r*, 44 TC 103 (1965), *acq.* 1966-2 CB 4; *Wynne v. Comm'r*, 47 BTA 731 (1942), *nonacq.* 1943 CB 42; Rev. Rul. 75-457, 1975-2 CB 196; Rev. Rul. 82-122, 1982-1 CB 180.

240. GCM 36299 (Jun. 5, 1975). Thus, it is important that the payment terms of the underlying promissory note remain unchanged. On this point, see *Burrell Groves, Inc. v. Comm'r*, 223 F.2d 526 (5th Cir. 1955).

241. The concept is also known as an Umbrella Partnership Real Estate Investment Trust (UPREIT)

242. IRC §721(a).

243. The partnership provides commercial farm management of farms under its ownership. The shareholders are passive.

From a legacy standpoint, it is possible to include in exchange documents controls on the sale of the farm, repurchase rights, and special usage rights.

Caution. Eight states have anti-corporate farming laws that could impact the use of the §721 exchange technique involving farmland in those states. North Dakota and Oklahoma have statutory provisions that bar corporate investment in agricultural land.[244] The North Dakota provision requires an LLP, when registering with the state, to certify whether the entity plans to engage in farming or own farmland, and, if so, reveal the name and address of each partner in the LLP.[245] In Oklahoma, an LLP is barred from owning agricultural land.[246] The Missouri and Wisconsin provisions do not bar the ability of LLPs to hold farmland and do not explicitly restrict an LLC from indirectly owning farmland.[247] Thus, in these states, the operating partnership should be structured as an LLP whose partners are wholly owned LLCs. In Iowa, Kansas, Minnesota, and South Dakota, it may be possible to use a parallel LLP structure with only individuals as the partners.

Monetized Installment Sale

In Chief Counsel Advice (CCA) 202118016,[248] the IRS expressed its concern about **monetized installment sales** that, via an intermediary and an installment note, purport to defer gain recognition and income tax due on the sale of appreciated assets, despite the seller having effectively received substantially all of the cash proceeds. With a monetized installment sale, a promoter asserts that property can be sold with an installment agreement, with the seller then entering into an escrow agreement with funds being borrowed against a note and achieving gain deferral. The IRS noted that such transactions lack any genuine indebtedness, involve deemed payments that the seller does not report, and uses intermediaries that do not truly acquire the property in accordance with §453.

Note. In the CCA, the IRS clearly stated that CCA 20123401F[249] did not support a monetized installment sale **unless the pledge involves the sale of agricultural property.**

The monetized installment sale technique has made the IRS "Dirty Dozen" tax scam list for 2021–2024, and the IRS has been pursuing promoters involved in such transactions.[250] In August 2023, the Treasury and IRS issued proposed regulations identifying monetized installment sale transactions and substantially similar transactions as listed transactions.[251]

Note. For more information on monetized installment sales and the other scams that made the IRS's Dirty Dozen list, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 7: IRS Update.

Note. Taxpayers use Form 8886, *Reportable Transaction Disclosure Statement*, to disclose information for each reportable transaction in which they participate. Material advisors must file Form 8918, *Material Advisor Disclosure Statement*, to disclose information about reportable transactions. Penalties apply to taxpayers and material advisors who fail to properly disclose their participation in reportable transactions.

244. N.D. Cent. §§10-06.1-20, 24; Okla. St. tit. 18, §§952(F), 955(B).

245. See Office of the N.D. Sec. of State, *Limited Liability Partnership Registration,* at no. 11.

246. Okla. Stat. tit. 18 §955.

247. Mo. Rev. Stat. §§350.010, 350.15; Wis. Stat. Ann. §182.001.

248. CCA 202118016 (Oct. 31, 2019).

249. CCA 20123401F (Jul. 18, 2012).

250. See, e.g., *Bishop v. U.S.*, No. 23-4020, 2023 U.S. App. LEXIS 31866 (10th Cir. Dec. 4, 2023), *cert. denied,* 144 S.Ct. 1460 (2024). The court upheld the denial of eight petitioners' motion to quash and ordered enforcement of IRS administrative summonses issued to financial institutions in a promoter investigation involving monetized installment sales.

251. 88 Fed. Reg. 51,756 (Aug. 4, 2023). The proposed regulations will apply as of the date of finalization.

The Proposed Treasury Regulations[252] provide that a transaction is a monetized installment sale transaction if, in connection with the transaction, and regardless of the order of the steps or the presence of additional steps or parties, any of the following elements exist.

- A taxpayer (seller), or a person acting on the seller's behalf, identifies a potential buyer for appreciated property (gain property), who is willing to purchase the gain property for cash or other property (buyer cash).
- The seller enters into an agreement to sell the gain property to a person other than the buyer (intermediary), in exchange for an installment obligation.
- The seller purportedly transfers the gain property to the intermediary, although the intermediary either never takes title to the gain property or takes title only briefly before transferring it to the buyer.
- The intermediary purportedly transfers the gain property to the buyer in a sale of the gain property in exchange for the buyer cash.
- The seller obtains a loan, the terms of which are such that the amount of the intermediary's purported interest payments on the installment obligation correspond to the amount of the seller's purported interest payments on the loan during the period (with only interest due over identical periods, with balloon payments of all or a substantial portion of principal due at or near the end of the instruments' terms, on each installment obligation and loan).
- The sales proceeds from the buyer received by the intermediary (reduced by certain fees, including an amount set aside to fund purported interest payments on the purported installment obligation) are provided to the purported lender to fund the purported loan to the seller (or transferred to an escrow or investment account of which the purported lender is a beneficiary), and the lender agrees to repay these amounts to the intermediary over the course of the term of the installment obligation.
- On the seller's federal income tax return for the tax year of the purported installment sale, the seller treats the purported installment sale as an installment sale under §453.

The preamble to the Proposed Treasury Regulations states that the Treasury Department and IRS are aware that promoters are marketing transactions that purport to convert a cash sale of appreciated property into an installment sale to an intermediary (who may be the promoter), followed by a sale from the intermediary to the buyer. The promotional materials for these transactions assert that engaging in the transaction allows the seller to defer the gain under the installment method until the taxpayer receives the balloon principal payment in the year the installment obligation matures, even though the seller receives cash from the purported lender in an amount that approximates the amount paid by the buyer to the intermediary.

The IRS asserts that such transactions fail installment treatment based on the following.

- The intermediary is not a bona fide purchaser of the gain property that is the subject of the purported installment sale.
- The seller is appropriately treated as having already received the full payment at the time of the sale to the buyer because:
  - The purported installment obligation received by the seller is treated as the receipt of a payment by the seller under Treas. Reg. §15a.453-1(b)(3) because it is indirectly secured by the sales proceeds, or
  - The proceeds of the purported loan are appropriately treated as a payment to the seller because the purported loan is not a bona fide loan for federal income tax purposes, or
  - The pledging rule of §453A(d) deems the seller to receive full payment on the purported installment obligation in the year the seller receives the loan proceeds.
- The transaction may be disregarded or recharacterized under the economic substance rules codified under IRC §7701(o) or the substance over form doctrine. The step transaction doctrine and conduit theory may also apply to recharacterize monetized installment sale transactions.

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252. Prop. Treas. Reg. §1.6011-13(a).

One of the clear conditions of §453 is that the debt obligation be incurred by the buyer of the property. If someone other than the purchaser of the property is the obligor, the debt is treated as a payment on the sale.[253]

> **Example 16.** Widget Collateral Company is a vendor of monetized installment sales. Its sales material purports that Widget is both the buyer and the obligor. However, in Widget's detailed summary of the transaction on its website, it states that the seller's deed is transferred directly to the actual buyer:
>
> > *... there is only one transfer of title or ownership... the final buyer will receive the same instrument of transfer from the same party with the same representations and warranties, on the same day and for the same price as would have been the case if Widget had not been involved.*
>
> At this point, the installment sale fails because Widget is the obligor. The actual buyer has paid cash which is held by Widget as agent for the seller. There is not an installment sale with a debt from the actual purchaser.

The buyer's funds cannot be escrowed for the benefit of the seller or to directly fund the installment obligation.[254]

> **Example 17.** Use the same facts as **Example 16,** except that Widget's material represents that the installment note is not directly pledged or used to provide security. However, its website material states that:
>
> > *... the lender does not require Widget to provide security because Widget agrees to invest the resale proceeds in accord with the lender's investment criteria.*
>
> In addition, Widget's promotional material describes a 3-account escrow arrangement, in which an escrow company takes an automatic monthly payment from Widget, moves that money to an escrow account of the seller, and then automatically transfers the funds to the lender's "loan escrow" to pay the debt each month.
>
> The result is that it is all pre-arranged with the funds automatically moving each month from Widget through a phantom account of the seller to then pay the lender. There are no economics in this for the seller, and the payments do not in any way provide income or loss to the seller, but are all pre-arranged to use the deposit of Widget from the land sale to fund the seller's bank debt in full. The transaction has no prospect of success with the IRS and is clearly within the scope of what the IRS is targeting in the proposed regulations.[255]

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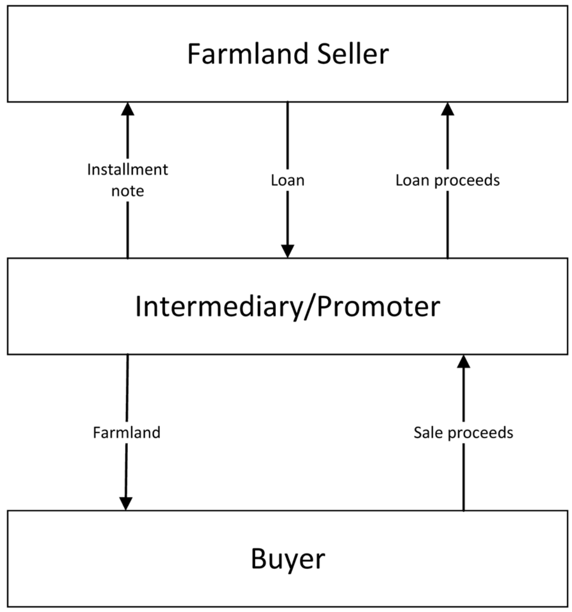
253. Treas. Reg. §15a.453-1(b)(3)(i).

254. IRC §453A(d)-1; Treas. Reg. §15a.453-1(b)(3)(i); Rev. Ruls. 79-91, 79-1 CB 179; 77-294, 1977-2 CB 173; and 73-451, 1973-2 CB 158; Ltr. Rul. 200521007 (May 27, 2005).

255. Some monetized installment sale promoters point to CCA 20123401F (Jul. 18, 2012). However, the CCA involved a direct sale from a seller to a third party whose debt obligation was direct, and the subsequent pledging of the debt was only for a portion and to a third party with no connection to the buyer or the buyer's escrowed funds. As the IRS stated, each step had independent economic significance and was done for business reasons. An improper monetized arrangement has as its substance a cash sale, with the promoter inserting itself between buyer and seller, and using a loan arrangement with the promoter's escrowed funds used to cash out the seller.

As noted, the pledge in a monetized installment sale can involve agricultural property.[256] Such a transaction can be diagrammed as follows.

Flow of Funds – Monetized Installment Sale of Farmland Transactions



Example 18. Nicholas sells $2 million worth of farmland on an installment basis to his son over 15 years with a note that will be amortized over the 15-year period. The note provides for 5% interest. Usurious State Bank loans Nicholas 95% of the face value of the note with an interest rate of 5% or higher. Scrooge Escrow Co. handles the collection of the proceeds from the sale and the offsetting loan payment to Usurious State Bank.

Nicholas receives 95% of his cash up front but will be able to spread the capital gain tax liability over 15 years.

Caution. If Nicholas spends the cash and has a large balloon payment, he may lack the funds to cover the taxes in later years. Also, if Nicholas were to die before the end of the 15-year term, his heirs would owe tax on the inherited note. If this occurs, the heirs will need cash available to pay the tax because cash is required to pay Usurious State Bank. The heirs will not receive a step up in basis.

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Summary

The following table summarizes the pros and cons of installment sales for retiring farmers.

Pros	Cons
Defer recognition of income	No step up in basis
Cash flow to seller	Depreciation recapture not eligible
Can elect out of deferral	May cause taxable SSB in more years
May avoid NIIT	May not be best financing option for buyer
May avoid Medicare B surtax	
Allows renegotiation if prices fall	

256. CCA 20123401F (Jul. 18, 2012).

SPLIT-INTEREST LAND ACQUISITIONS

A **split-interest purchase arrangement** involves the purchase of an asset by two parties. One party acquires an income interest in the asset for life and the other party acquires a remainder interest. Each party pays their respective proportionate share of the cost based on IRS actuarial tables for life estate and remainder interests based on their ages. Historically, the technique has been utilized to remove after-tax income from a family corporation, as well as brokering the cost of a farmland purchase to be covered by the corporation without trapping the asset inside the corporation.[257] The split-interest technique can, perhaps, be used as a mechanism to get farmland in the hands of a subsequent generation of the family.

> **Note.** For more information and additional background on the split-interest technique, see the 2016 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 7: Agricultural Issues and Rural Investments, pp. 325–331. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

The first step in the computations is to identify, for the month of the transaction, the rate that is 120% of the AFR for the midterm category and round to the nearest two-tenths of 1%. For July 2024, the 120% AFR midterm rate is 5.40%. This is rounded to 5.40% for the IRC §7520 rate.[258]

Example 19. Abe and his nephew Lot agree to acquire farmland they believe will appreciate in value. The land is presently valued at $200,000. If Abe is 55 years old, assuming a §7520 rate of 5.2%, his life income interest from IRS Table S[259] (shown next), is worth 70.42% ($140,840) of the full value of the property, and he pays that portion of the $200,000 purchase price.[260] Lot contributes the balance of $59,160 (29.58% from IRS Table S) as his share of the $200,000 purchase price.[261]

Table S - Based on Life Table 2010CM

Interest at 5.2 Percent

Age	Annuity	Life Estate	Remainder	Age	Annuity	Life Estate	Remainder
0	18.5724	0.96577	0.03423	55	13.5423	0.70420	0.29580
1	18.6565	0.97014	0.02986	56	13.3316	0.69324	0.30676
2	18.6346	0.96900	0.03100	57	13.1150	0.68198	0.31802
3	18.6089	0.96766	0.03234	58	12.8924	0.67040	0.32960
4	18.5806	0.96619	0.03381	59	12.6636	0.65851	0.34149
5	18.5499	0.96459	0.03541	60	12.4284	0.64628	0.35372
6	18.5173	0.96290	0.03710	61	12.1866	0.63370	0.36630
7	18.4828	0.96110	0.03890	62	11.9380	0.62078	0.37922
8	18.4461	0.95920	0.04080	63	11.6825	0.60749	0.39251
9	18.4073	0.95718	0.04282	64	11.4202	0.59385	0.40615
10	18.3662	0.95504	0.04496	65	11.1515	0.57988	0.42012
11	18.3228	0.95279	0.04721	66	10.8772	0.56561	0.43439
12	18.2773	0.95042	0.04958	67	10.5982	0.55110	0.44890
13	18.2299	0.94795	0.05205	68	10.3141	0.53633	0.46367
14	18.1812	0.94542	0.05458	69	10.0252	0.52131	0.47869
15	18.1313	0.94283	0.05717	70	9.7309	0.50601	0.49399
16	18.0804	0.94018	0.05982	71	9.4315	0.49044	0.50956
17	18.0283	0.93747	0.06253	72	9.1276	0.47463	0.52537
18	17.9750	0.93470	0.06530	73	8.8200	0.45864	0.54136
19	17.9203	0.93186	0.06814	74	8.5095	0.44250	0.55750

257. See generally, *Richard Hansen Land, Inc. v. Comm'r,* TC Memo 1993-248 (Jun. 2, 1993).

258. Rev. Rul. 2024-13, 2024-28 IRB 18.

259. *Table S.* IRS. [www.irs.gov/pub/irs-tege/table-s-2010cm-final.xlsx] Accessed on Jul. 29, 2024.

260. See IRS Pub. 1457, *Actuarial Valuations Version 4A*.

261. Ibid. It is important that the remainder holder furnish the consideration for the actuarial value of the remainder interest to avoid an IRS claim that, upon purchase of the property, the life tenant made a gift of a future interest to the remainder holder to the extent the value of the property exceeds the amount the remainder holder pays. IRC §2702. For purposes of §2702, a member of the family is defined by IRC §2704(c)(2) to include the individual's spouse, any ancestor or lineal descendant of the individual or the individual's spouse, any brother or sister of the individual, or any spouse of any individual that is an ancestor or lineal descendant of the individual or sibling of the individual.

Assuming the arrangement is structured properly, Abe will receive the right to possess the farmland or enjoy any income it produces for his life.[262] If the property produces a 5% return, Abe will receive $10,000 annually, which exceeds 5% of $140,840. If Abe outlives the actuarial life expectancy built into the IRS assumptions of IRS Pub. 1457, *Actuarial Valuations Version 4A,* he will continue to enjoy the property (receive the income from it). Abe will be taxed on the income received from the property during his life.

Each year, the ownership value belonging to Abe decreases as his income interest declines in value. Lot's ownership value increases by the same amount. At age 70, Abe's ownership portion will be 50.601% and Lot's will have increased to 49.399%. This ownership transfer is not a taxable event. Lot becomes the outright owner of the land upon Abe's death. The property is not included in Abe's estate and, thus, Lot does not receive a basis step-up to FMV as of the date of Abe's death. Lot's tax basis will be $200,000.

Note. Rising interest rates make split-interest transactions more attractive for transition planning. If the applicable interest rate was 1%, at age 55, Abe would only have contributed 23.223% of the purchase price. With an interest rate of 5.2%, Abe must contribute 70.420% of the purchase price. Higher rates allow the senior owner to acquire a greater ownership interest up front and transfer a greater portion over time to the next generation. Higher rates also allow a much smaller contribution by the younger owner.

Caution. Each party to the transaction should pay the actuarial value of their respective interest, the property should be purchased from an unrelated third party, and the life tenant's control, rights, and duties should be consistent with those of a life tenant. Also, the life tenant should not provide financing to the remainder holder. If that occurs, the IRS could take the position that the life tenant acquired an interest in the entire property with a gift of the remainder interest and retained life income, resulting in the inclusion of the life interest in the life estate holder's estate at death, subject to estate tax.

If the parties to the split-interest transaction are **unrelated,** the transaction can be advantageous for income and transfer tax purposes.[263]

- The term interest holder's interest can be amortized on a straight-line basis over the number of years of the term.
- If the property is fairly valued by at least one independent and qualified appraiser, there is no gift tax on creation of the interest if the IRS Tables are used to determine the actuarial contributions of the life tenant and the holder of the remainder interest.
- The termination of the life tenancy upon the death of the life tenant is not a transfer by the life tenant. Thus, there is no estate tax implication and any appreciation in the asset's value is also not included in the life tenant's estate.
- The asset, upon the life tenant's death, is owned by the remainder holder and avoids probate in the life tenant's estate.

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262. Based on his life expectancy, Abe may enjoy more income from the property than he would have received if he had invested the amount of his contribution to acquire another asset of the same type.

263. IRC §167(e)(1).

If the parties to the split-interest transaction are **related,** there is an immediate gift tax consequence. Also, no amortization is allowed if the remainder portion is held, directly or indirectly, by a related party.[264] A related person is defined under §267(b) if they fall in any of the following categories.

- Brothers and sisters of the individual (whether by the whole or half-blood)
- Spouse of the individual
- Ancestors of the individual

Lineal descendants of the individual

> **Note.** Any attempt to create an amortizable split-interest land acquisition by structuring an arrangement between unrelated parties must be scrutinized in terms of analyzing the §267 related party rules and family attribution definitions.

TAX REPORTING OF FARM PROGRAM PAYMENTS

For farmers participating in the federal farm programs, payments received will have a corresponding Form 1099-G, *Certain Government Payments,* with the amount of the payments shown in Box 7. An exception to this is for market gain income, which is shown in Box 9.[265]

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.

1 Unemployment compensation $

2 State or local income tax refunds, credits, or offsets $

OMB No. 1545-0120

Form **1099-G**

(Rev. March 2024)

For calendar year ______

Certain Government Payments

PAYER'S TIN

RECIPIENT'S TIN

3 Box 2 amount is for tax year

4 Federal income tax withheld $

Copy B

For Recipient

RECIPIENT'S name

5 RTAA payments $

6 Taxable grants $

Street address (including apt. no.)

7 Agriculture payments $

8 If checked, box 2 is trade or business income ☐

9 Market gain $

City or town, state or province, country, and ZIP or foreign postal code

10a State

10b State identification no.

11 State income tax withheld $ $

Account number (see instructions)

This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

Form **1099-G** (Rev. 3-2024) (keep for your records) www.irs.gov/Form1099G Department of the Treasury - Internal Revenue Service

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264. IRC §167(e)(3).

265. A market gain payment is associated with a marketing assistance loan. Also, many state program payments are reported on Form 1099-G.

TYPES OF PAYMENTS

Farmers receive several types of farm programs payments. Practitioners should be aware of the different types of payments and how to report them.

Agricultural Risk Coverage and Price Loss Coverage[266]

Agricultural risk coverage (ARC) and price loss coverage (PLC) payments are paid as the result of lower prices, yields, or both. As such, they provide a farmer with a safety net. The payments are reported to the IRS and the producer on Form 1099-G. These payments are issued at least one year after harvest of the associated crop, are reported in the year of receipt, and are not deferrable.

Supplement Coverage Option and Enhanced Coverage Option

Supplement coverage option (SCO) and enhanced coverage option (ECO) are types of crop insurance that provide additional area-based coverage for a portion of a farmer's underlying crop insurance policy that is purchased as an endorsement. These payments are not deferrable beyond the year of receipt because they are based on either county yield or the farmer's Schedule F income. Likewise, rainfall insurance proceeds are not deferrable because payment is based on rainfall amounts and not on actual physical damage to the farmer's crops.[267] These payments are reported on Form 1099-MISC, *Miscellaneous Information,* Box 9, *Crop Insurance Proceeds.*

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		**1** Rents $	OMB No. 1545-0115 Form **1099-MISC** (Rev. January 2024) For calendar year ______	**Miscellaneous Information**
		2 Royalties $		
		3 Other income $	**4 Federal income tax withheld** **$**	**Copy B** **For Recipient**
PAYER'S TIN	RECIPIENT'S TIN	**5** Fishing boat proceeds $	**6** Medical and health care payments $	
RECIPIENT'S name		**7** Payer made direct sales totaling $5,000 or more of consumer products to recipient for resale ☐	**8** Substitute payments in lieu of dividends or interest $	This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address (including apt. no.)		**9** Crop insurance proceeds $	**10** Gross proceeds paid to an attorney $	
City or town, state or province, country, and ZIP or foreign postal code		**11** Fish purchased for resale $	**12** Section 409A deferrals $	
	13 FATCA filing requirement ☐	**14** Excess golden parachute payments $	**15** Nonqualified deferred compensation $	
Account number (see instructions)		**16** State tax withheld $ $	**17** State/Payer's state no.	**18** State income $ $

Form **1099-MISC** (Rev. 1-2024) (keep for your records) www.irs.gov/Form1099MISC Department of the Treasury - Internal Revenue Service

266. *FSA Handbook: Agriculture Risk Coverage and Price Loss Coverage Program — 1-ARCPLC (Revision 1)*. Feb. 27, 2024. FSA. [www.fsa.usda.gov/Internet/FSA_File/1-arcplc_r01_a13.pdf] Accessed on Jul. 16, 2024.

267. IRS Pub. 225, *Farmer's Tax Guide,* p. 12 (2023).

Emergency Relief Program[268]

The USDA issued emergency relief program (ERP) payments related to crop losses on account of natural disasters for 2020-2022. The application deadline for "Track 2" was Aug. 14, 2024, and most of the 2022 "Track 2" payments will be received in 2024. ERP payments are not deferrable because the payments are attributable to crop damage that occurred in a prior year.

Commodity Credit Corporation Loans[269]

The Commodity Credit Corporation (CCC) is the USDA's financing institution. Among other things, the CCC makes commodity loans to farmers where the farmers' crops are pledged as collateral. These loans are part of the price and income support system of the federal farm programs. Upon repayment of the loan (known as **redemption**), the farmer can sell the grain, feed it to livestock, or store it. However, most CCC loans are nonrecourse so that, upon maturity, if the loan plus interest is not paid, the commodity may be forfeited to the CCC as full payment for the loan. That effectively establishes a minimum price insomuch as the farmer can forfeit the grain if prices drop below the loan value and still retain the ability to market the grain later if the commodity price increases.

> **Note.** CCC loans are not reported on Form 1099-G.[270]

Farmers can report the loan proceeds under either the **loan method** or the **income method.** This option allows tax planning strategies to increase taxable income or to increase cash flow when the producer is not ready to sell the crop.[271] The following portion of Schedule F includes lines relevant to reporting income from agricultural program payments, CCC loans, and crop insurance proceeds.

3a	Cooperative distributions (Form(s) 1099-PATR)	3a		3b	Taxable amount	3b	
4a	Agricultural program payments (see instructions)	4a		4b	Taxable amount	4b	
5a	Commodity Credit Corporation (CCC) loans reported under election					5a	
b	CCC loans forfeited	5b		5c	Taxable amount	5c	
6	Crop insurance proceeds and federal crop disaster payments (see instructions):						
a	Amount received in 2023	6a		6b	Taxable amount	6b	
c	If election to defer to 2024 is attached, check here ☐			6d	Amount deferred from 2022	6d	
7	Custom hire (machine work) income					7	

It is presumed that every farm taxpayer treats CCC loans as loans for tax purposes. In this event, taxpayers on the cash method of accounting do not have taxable income until the year in which the commodity is sold or the crop is forfeited to CCC in full satisfaction of the loan. If grain is forfeited to the CCC in satisfaction of the loan, the taxpayer receives a Form 1099-A, *Acquisition or Abandonment of Secured Property,* from the USDA. The amount of the loan forfeited is reported on line 5b of Schedule F with the same amount entered as taxable income on line 5c if not previously reported as taxable income.[272]

> **Note.** The loan method often creates large amounts of income with no cash flow in the year the grain is sold because the loan amount was received in the prior year.

268. *FSA Handbook: Emergency Relief Programs — 1-ERP*. Oct. 2, 2023. FSA. [www.fsa.usda.gov/Internet/FSA_File/1-erp_r00_a06.pdf] Accessed on Jul. 16, 2024.

269. *Commodity Credit Corporation.* U.S. Department of Agriculture. [www.usda.gov/ccc] Accessed on Jul. 29, 2024.

270. IRS Pub. 225, *Farmer's Tax Guide*.

271. Treas. Regs. §§1.77-1 and 1.77-2.

272. Ibid.

CCC loans may, by election, be treated as income in the year the proceeds of the loan are received.[273] If a farmer elects to treat CCC loans as income, it applies to all loans for all commodities that year.[274]

Observation. The CCC loan is not income. Rather, the amount reported as income is the cash proceeds of the CCC loan which then serves as the grain's tax basis.[275]

The amount of the income is entered on line 5a of Schedule F. The election is required to be made only once during a taxpayer's lifetime. A taxpayer may elect at any time to report CCC loans as income.[276] If the taxpayer does not elect to treat the loans as income, the income is reported in the year the commodity is sold or forfeited to the CCC.

Note. Effective for taxable years ending on or after December 31, 2001, IRS has ruled that a taxpayer reporting CCC loans as income can switch automatically to treating CCC loans as loans.[277]

The change is made on a cut-off basis.[278] In other words, when a taxpayer changes CCC loan reporting methods, the new method applies to current year and subsequent loans. Thus, a farmer could be reporting on both methods until prior loans are satisfied. In addition, even if a farmer had made the election to report the CCC loan as income within the past five years, the farmer is still eligible to switch to the loan method. The IRS waives that 5-year prohibition.[279] Form 3115, *Application for Change in Accounting Method,* must be attached to the return noting that the change is made under the automatic consent procedures of Rev. Proc. 2015-14. A copy of Form 3115 must be sent to the IRS in Washington, D.C.

The following table shows the income tax treatment of various dispositions of CCC loans and commodities.

	Treatment of CCC Loan When Received	
Disposition of the Loan or Commodity	**Treated as Income (Election Made)**	**Treated as Loan (No Election)**
1. Loan paid by forfeiting commodity	No income reported	Amount of loan reported as income
2. Commodity redeemed by paying off loan with cash	Farmer has basis in commodity equal to loan amount	Farmer has a zero basis in the commodity
3. Redeemed commodity is sold	Farmer has income (loss) equal to sale price less amount of loan, which is the basis in the commodity	Farmer has income equal to sales price
4. Redeemed commodity is fed	Farmer has a feed deduction equal to the amount of the loan, which is the basis in the feed commodity	Farmer has no deduction

273. IRC §77.

274. Treas. Reg. §1.77-1.

275. IRS Pub. 225, *Farmer's Tax Guide*.

276. IRC §77(a).

277. Rev. Proc. 2002-9, 2002-3 IRB 327, Appendix, §1.01(1). Loans taken out previously continue to be treated as if the election to report loans as income was still in effect.

278. Ibid.

279. Rev. Proc. 2015-13, 2015-5 IRB 419, Appendix §2.01(2).

Normally, the repayment of a CCC loan is of no consequence, regardless of whether the taxpayer has made an election to treat the loans as income. However, if a farmer has elected to treat CCC loans as income, the courts are divided as to the outcome if loans are redeemed in the same year they are taken out. The Fifth Circuit Court of Appeals held that no income is realized from the loan on a crop redeemed in the same year.[280] Conversely, the Ninth Circuit Court of Appeals took the position that the loan triggers income even though redeemed.[281]

However, if the value of the crop subject to the CCC loan drops below the loan amount and the farmer elects to "pay" the loan at the lower value, the difference between the loan amount and the FMV of the crop is a **market gain.** In this situation, the CCC will issue a Form 1099-G. If the farmer elected to treat the loan as income in the year the loan was received, the market gain is not reported as income, however the farmer's basis in the crop associated with the loan will be reduced. Alternatively, if the farmer treated the loan as a loan, the amount shown on the Form 1099-G will be reported as income in the year the crop is forfeited. [282]

Caution. Often the commodity under a CCC loan is stored at a commercial elevator and when the crop is sold, the elevator pays off the CCC loan to remove the lien prior to completing the sale. The farmer then only receives a payment for the grain value exceeding the loan amount. Without proper accounting for the full sale price, farm taxpayers have a risk of omitting gross receipts from grain sales.

Example 20. Sarah Dippity is a corn farmer. In 2023, she places 10,000 bushels of corn under loan with the CCC and receives loan proceeds of $40,000 ($4 per bushel). In 2024, the price of corn drops to $3.75 per bushel. Sarah then redeems her corn by paying the CCC $37,500. She then later sells her corn for $42,500.

Sarah is on the loan method and did not include the loan as income when she received it. Therefore, she has a market gain of $2,500 ($40,000 loan proceeds – $37,500 CCC redemption) to report on Schedule F. When Sarah sells the corn for $42,500, she reports the sale on line 2. In 2024, Sarah reports $45,000 in income ($40,000 loan + ($42,500 sales proceeds – $37,500 price for 10,000 bushels at $3.75 per bushel)).

Example 21. Use the same facts as **Example 20,** except that Sarah is on the income method. She originally reported the $40,000 loan as income in 2023 which gave the crop a basis of $40,000. The market gain is not reported as income, but reduces the basis in the corn to $37,500. When the crop is sold for $42,500, Sarah reports the sale on line 1a and then report the cost of the sale on line 1b of $37,500, for a net gain of $5,000. The total amount of income reported in 2024 is $5,000 plus the $40,000 reported in 2023.

Feed Assistance[283]

Feed assistance payments may be made to a qualifying livestock producer upon the occurrence of a natural disaster or livestock emergency. The assistance is either in the form of lower feed cost or direct donations. The producer may include in income the amount of donated feed received based on the feed's FMV, the difference between the FMV of the feed and the amount the producer paid for the feed, or the cost reimbursement received. Any amounts will be reported on Schedule F, line 4a and 4b.[284]

Note. The amount of income reported is not deferrable under the provisions for weather-related sales of livestock because the payments are for feed, not livestock. However, the producer can deduct the income as additional feed cost with the net effect being zero (depending on the producer's method of accounting).

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

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

282. IRS Pub. 225, Farmer's Tax Guide.

283. Ibid.

284. This is the case even though Form1099-G may not be received.

Cost Share Exclusion

Under certain federal farm programs, especially those programs designed to provide environmental benefits (e.g., conservation, reclamation, or restoration), the USDA shares part of the expense associated with complying with the program. For example, under a particular USDA soil conservation program, a farmer may be encouraged to build terraces in crop fields to reduce or eliminate soil erosion. The farmer incurs an expense associated with building the terraces and the USDA pays the farmer a portion of that expense. The IRS permits some cost sharing amounts received by farmers and ranchers under several state and federal programs to be excluded from gross income.[285]

For amounts paid under eligible programs to be excludable, **three requirements** must be satisfied.

1. The Secretary of Agriculture must determine that the payments are made "primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife."[286]
2. The Treasury Secretary must determine the expenditures made under the program are not "increasing substantially" the annual income from the property.[287]

> **Note.** An increase in annual income is not substantial unless it exceeds the greater of $2.50 per acre or 10% of the average annual income derived from the property prior to the improvement.[288] Practitioners that have clients receiving these payments should consult Temp. Treas. Reg. §16A.126-1 for an example and the relevant formulas.

3. No part of a payment can be excluded if it is for an expense that is allowed to be deducted in the current tax year.

Example 22. Mindy owns a 640-acre farm in Indiana. She received gross income of $64,000 from crop production over each of the last three years. In 2024, Mindy installed a soil conservation terrace to comply with a soil and water conservation plan for the farm. The terrace cost $48,000, and increased the value of her farm by $27,000. Mindy received a $24,000 cost-share payment from the local FSA office, which she reported as a government payment. Mindy meets all of the tests for excludability. In determining how much of the $24,000 cost-sharing payment can she exclude from income, Mindy performs the following computations.

Computation of the 10%/$2.50-per-acre limit:

10% = $6,400

$2.50 × 640 = $1,600

Therefore, 10% of the rent ($6,400) is greater than $2.50 times 640 acres ($1,600). Part or all of the $24,000 cost-share amount is excludable if the annual income does not increase more than $6,400 because of the terrace.

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285. Cost-sharing payments received under the Wetlands Reserve Program (WRP), the Environmental Quality Incentives Program (EQIP), and the Wildlife Habitat Incentives Program (WHIP) are eligible for exclusion from gross income. Rev. Rul. 97-55, 1997-52 IRB 7 (WRP, EQIP, and WHIP are substantially similar to programs described in IRC §§126(a)(1)–(8)). The IRS has ruled similarly with respect to cost-share payments received under the Conservation Reserve Program, Rev. Rul. 2003-59, 2003-24 IRB 1014; the Forest Land Enhancement Program (FLEP), Rev. Rul. 2004-8, 2003-10 IRB 544; and the Conservation Security Program, Rev. Rul. 2006-46, 2006-2 IRB 511. IRS Pub. 225 lists the programs that qualify.

286. IRC §126(b)(1)(A).

287. IRC §126(b)(1)(B).

288. Temp. Treas. Reg. §16A.126-1.

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Computation of the excludable amount, based on the formula described in Temp. Treas. Reg. §16A.126-1(g):

1. Determine the value of the improvement.

$$\begin{aligned}\textbf{Value of improvement} &= \textbf{Improvement FMV} \times \frac{\textbf{§126 cost}}{\textbf{Cost of improvement}} \\ &= \$27{,}000 \times \frac{\$48{,}000}{\$48{,}000} \\ &= \$27{,}000\end{aligned}$$

2. Determine the excludable portion (the present FMV (PFMV) of the greater of 10% of annual income (or $2.50), times the number of acres affected).

$$\frac{\$6{,}400}{.06\ \text{(assumed PFMV discount factor)}} = \$106{,}667$$

3. Determine Mindy's cost associated with the improvement.

$24,000

4. Add the results of Steps 2 and 3.

$$\$24{,}000 + \$106{,}667 = \$130{,}667$$

5. If the result of Step 4 exceeds the value of the improvement, the entire amount of cost-share payment can be excluded from income if annual income does not increase more than $6,400.

Value of improvement	$27,000
Less: Mindy's contribution	(24,000)
Amount includable in gross income	$ 3,000

If Mindy had **not** made an election to exclude the cost-share amount, she would have included $3,000 in gross income in addition to the $24,000 cost share program payment.[289] She also would have $51,000 of cost added to the depreciation schedule ($48,000 purchase price + $3,000 includable in gross income).

If Mindy made an election to exclude the cost share amount, she would have $24,000 of cost added to the depreciation schedule ($48,000 purchase price – $24,000 excluded income).

The excluded amount is reported by attaching a statement to the return for the tax year of receipt of the last government payment for the improvement. The statement must denote the dollar amount the government funded, the value of the improvement, and the amount being excluded. The total cost-share payment is reported on Schedule F, line 4a with the taxable amount on line 4b.[290]

> **Note.** If payments are reported on Form 1099-G in multiple years, the payment received should be reported on line 4a and nothing on line 4b, with an accompanying statement attached to the return.

289. The election **not** to exclude the payment must be made on a timely filed return by simply reporting the income on line 4b of Schedule F.

290. 2023 IRS Pub. 225, *Farmer's Tax Guide*, pp. 13–14.

If property on which cost-sharing payments have been excluded from gross income is disposed of within 20 years, part or all of the excluded payments are taxed as ordinary income. The amount taxable as ordinary income is the lesser of the gain realized on sale of the property or the applicable percentage of the amount of the payment that had been excluded from income. The applicable percentage for the first 10 years after the date payments are received and excluded is 100%. Thereafter, the applicable percentage is reduced annually by 10%. After the 19th year, there is no recapture. However, the exclusion and recapture rules do not apply to government cost sharing payments to the extent a deduction is allowed in the year paid or incurred. Furthermore, if the exclusion is claimed, expenditures may neither be used to generate deductions or credits, nor be added to the income tax basis of property acquired. The exclusion for cost sharing payments is available to landlords also.[291]

AGRICULTURE-RELATED RULINGS AND CASES

The following are some agriculture-related rulings and cases from the past year.

Accounting Method

Impermissible Change to Amortize Base Acres Was a Change in Accounting Method

Conmac Investments, Inc. v. Comm'r, TC Memo 2023-40 (Mar. 27, 2023)

Conmac Investments was a corporation that owned and leased farmland to tenant farmers under oral leases. Conmac did not personally farm any of the land. The farmland contained **base acres** — such as wheat, corn, soybeans, cotton, rice, etc., from the USDA. The farm program payments (paid pursuant to the 2008 and 2014 Farm Bills) were paid to the tenants. Under the oral leases, the tenants received all of the payments attributable to the base acres and the annual rent payment was generally 25% of the gross income from the farmland, with gross income from the farmland including any farm subsidy payments received on account of the base acres.

Before 2009, Conmac did not claim any deductions for amortization or depreciation of the base acres. However, starting in 2009, Conmac began claiming an amortization or depreciation deduction for base acres acquired and placed in service in 2004 through 2013 (i.e., asserting an ownership interest in an intangible asset). To determine the claimed deductions, Conmac developed a methodology to calculate an average farm subsidy payment per base acre rented to tenant farmers. Conmac, selecting 2009 as the reference year, determined its average farm subsidy payment per rented-out base acre to be $39.62. Conmac then calculated the present value of its average farm subsidy payment over a 15-year period, which worked out to be $431.81. Using this present value, Conmac derived a proposed amount for the amortization or depreciation of its base acres each year, multiplying its total number of rented-out base acres by $431.81 and then dividing that amount by 15 to recognize the amortization or depreciation expense on a straight-line basis over 15 years. Using the methodology it devised, Conmac reported amortization or depreciation expenses for base acres rented to tenant farmers of $141,614 for 2009 through 2012, $48,373 for 2013, and $44,980 for 2014. By deducting its amortization expense, Conmac reduced its recognition of income paid by the tenant farmers. Changing the treatment of an asset from non-depreciable to depreciable or non-amortizable to amortizable (or vice-versa) is a change of accounting that results in a §481 adjustment.

> **Note.** It is unknown why Conmac decided to claim deductions against, essentially, cash rent. It was the tenants that were assuming the risk of production under the leases, not Conmac. In essence, Conmac started claiming deductions against guaranteed rental income without assuming any of the risk of the expenses under the leases.

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[291] Ltr. Rul. 9014041 (Jan. 5, 1990).

However, Conmac did not attach Form 3115 to its Form 1120 or otherwise seek IRS consent to change its accounting method. Conmac also did not file amended returns with an explanatory statement for all open years reclassifying the base acres as amortizable under IRC §197. Additionally, Conmac did not adopt the same accounting treatment for all bases acres that it owned.

The IRS determined that Conmac adopted an impermissible method of accounting and asserted deficiencies of approximately $116,000 for 2013 and $114,000 for 2014, and that a §481 adjustment of $141,614 for 2009–2012 was required. Conmac claimed that it had not changed its accounting method because of a change in underlying facts impacting its business. In addition, Conmac claimed that even if there was a change in the underlying facts that supported an accounting method change, the lack of IRS consent did not matter because the relevant tax years had closed. Conmac claimed that a §481 adjustment was not necessary because it should have been made for the year of change (e.g., 2009) and that the IRS could no longer require the adjustment because 2009 was a closed tax year.

The Tax Court (opinion by Judge Paris) agreed with the IRS noting that Conmac had changed an accounting method in violation of IRC §446(e) which requires IRS consent for such a change, and that a §481 adjustment was proper. The facts did not involve the application of an existing accounting method to a change in business practices. Indeed, there was no change in business practices — Conmac continued to serve as landlord to the tenant farmers and did not change the terms of the leases. Instead, the only economic consequence was the tax benefit that Conmac received on account of the change — there was no change in existing legal or economic relationships. In addition, Conmac continued to treat base acres acquired and placed in service in other years as non-amortizable or non-depreciable. The Tax Court determined that Conmac simply made a business decision in 2009 to start claiming amortization deductions on farmland that it had acquired and placed in service beginning in 2004. The corporation, the Tax Court pointed out, failed to identify the facts that had changed, causing it to change its tax treatment of the rented farmland.

Judge Paris referenced *Comm'r v. Brookshire Brothers Holding, Inc.,*[292] In that case, the appellate court, affirming the Tax Court, held that an IRS challenge to a method change for which consent was not given must be for the year of the improper change, and that failure to obtain prior consent did not serve as a basis to challenge the change for a closed year. In the present case, the Tax Court distinguished *Brookshire* on the basis that Conmac did not file amended returns with an explanatory statement for all open years reclassifying the base acres. In addition, based on the corporation's inconsistent treatment of the base acres depending on the year the farmland was placed in service, the Tax Court determined that finding an unauthorized change in accounting would promote consistency and would not offend basic fairness.

The Tax Court sustained the §481 adjustment. The Tax Court rejected Conmac's argument that the §481 adjustment was barred by the statute of limitations after finding that the year of the change was the oldest open tax year. The Tax Court explained that the only limitation on a §481(a) adjustment is that no pre-1954 adjustments may be made. As long as a change in an accounting method has occurred, the IRS may adjust a taxpayer's income in an open year to reflect amounts attributable to years for which the applicable statute of limitations has expired (i.e., time-barred years).[293]

Conservation Easements

Burden of Proof on Reasonable Cause for Substantiation Rules

Murfam Enterprises, LLC v. Comm'r, TC Memo 2023-73 (Jun. 15, 2023)

Murfam, a privately held company of a multi-generation hog farming family in North Carolina, obtained a 6,171-acre parcel of land named the "Rose Tract." The State of North Carolina granted hog-farming certificates that were attached to the Rose Tract. The certificates authorized a "feeder-to-finish" facility but it could be converted into an authorization for a "farrow-to-wean" facility.

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292. *Comm'r v. Brookshire Bros. Holding, Inc.,* 320 F.3d 507 (5th Cir. 2003), *aff'g* TC Memo 2001-150 (Jun. 22, 2001).

293. *Huffman v. Comm'r*, 518 F.3d 357 (6th Cir. 2008), *aff'g* 126 TC 322 (2006).

In 2007, North Carolina imposed a moratorium on issuing new hog-farming certificates. In 2010, Murfam donated a conservation easement on the entire tract to a qualified land trust. The easement specified the Rose Tract could not be used for hog farming and Murfam claimed a charitable deduction of $5,744,600 (the value of the certificates) for the donation of the easement.

The IRS asserted that the value of the charitable deduction was $446,000. The Tax Court used the **highest and best use method** to determine the value of donated easement. In doing so, it relied heavily on the calculations of Murfam's expert, who determined that a farrow-to-wean facility was the most profitable use for the property before the easement. The IRS expert only examined the financials of building a feeder-to-finish facility and found that operation to be "financially unfeasible." In calculating the value of the easement, the court first took the value of the hog-farming facility plus the stipulated value of the remaining acreage to determine the initial value of the tract prior to the easement donation. It then subtracted the stipulated value of the land after the donation to determine that the value of the easement was $5,637,207.

However, when Murfam filed its pretrial memorandum, the IRS asserted that the deduction should be disallowed due to Murfam's failure to comply with IRC §170(f)(11). Under §170(f)(11), a taxpayer must substantiate charitable deductions associated with a donated conservation easement by attaching a fully completed appraisal summary that includes the basis of the property unless the taxpayer has reasonable cause for not doing so. This case presented the issue of which party bears the burden of proof on the reasonable cause defense when the IRS raises the issue of noncompliance as a "new matter" in litigation, and when reasonable cause for the noncompliance is at issue.

The Tax Court held that when the issue of noncompliance is a "new matter," the burden of proof shifts to the IRS. The Tax Court reasoned that the Final Partnership Administrative Adjustment (FPAA) issued to Murfam indicated that a deduction was allowable, but for much less than what Murfam was claiming, and that Murfam bore the burden of proof on the value of the charitable deduction. However, the Tax Court held that the IRS bore the burden of proof on the substantiation issue. Murfam based its reasonable cause argument on its reliance on a competent CPA who was provided necessary and sufficient tax information, and that Murfam relied on the CPA in good faith. No penalty resulted because the valuation of the donation was within 2% ($5,637,207 ÷ $5,744,600 = 98.13%) of the amount that the Tax Court determined to be correct.

Suit Barred by Anti-Injunction Act

Rocky Branch Timberlands, LLC v. U.S., No. 22-12646, 2023 U.S. App. LEXIS 23606 (11th Cir. Sep. 6, 2023), *cert. den.* 144 S. Ct. 812 (Feb. 20, 2024)

Rocky Branch Timberlands sued for an injunction and declaratory relief after the IRS issued an FPAA disallowing a $26.5 million charitable deduction for a conservation easement on land donated to a charity. The trial court dismissed the case on the basis that the Anti-Injunction Act (AIA) barred the relief sought. Rocky Branch claimed that IRC §7803(e)(4) gave it the right to seek administrative review with the IRS Independent Office of Appeals, but was denied a hearing before the IRS issued the FPAA denying the deduction. Rocky Branch claimed that the AIA did not bar suits challenging the IRS's conduct rather than collection of tax. The appellate court affirmed, finding that the FPAA disallowed the deduction that resulted in the underpayment of tax, which the IRS would not be able to collect even if the court granted the requested relief. The appellate court also noted that the AIA's equitable exception did not apply because Rocky Branch had another remedy available — filing suit in the U.S. Tax Court. The appellate court further noted that Rocky Branch had not shown that the IRS could not prevail on the merits of the case.

Winning in Tax Court Does Not Mean You Are a "Prevailing Party"

Champion's Retreat Golf Founders, LLC v. Comm'r, TC Memo 2023-134 (Nov. 8, 2023)

IRC §7430 allows a court to award **reasonable administrative costs** and **reasonable litigation costs** to a taxpayer that is a **prevailing party** in a dispute with the IRS. Champions Retreat Golf Founders claimed a $10.8 million charitable deduction for a donated conservation easement on a 348-acre golf course and driving range. The IRS disallowed the deduction in its entirety, but also took a fallback position that the easement was worth $20,000. The Tax Court denied the deduction, but the Eleventh Circuit vacated the Tax Court's decision and remanded the case.[294] The Eleventh Circuit determined that the easement qualified as an open space easement under §170(h)(4)(A). On remand, the issue was the proper valuation of the easement. Ultimately, the Tax Court allowed a deduction of slightly under $8 million.[295]

In the present case, Champions sought to have the government pays its litigation costs because Champion was a prevailing party. The Tax Court disagreed. Under §7430(c)(4)(B), a taxpayer is not a prevailing party if the government can show that its position was **substantially justified** at the relevant time as to the issue or issues that the taxpayer won. The burden of proof is on the government.[296] The Tax Court determined that the government was substantially justified in its position that the easement was not a **qualified** easement because (as the IRS claimed) there was insufficient access to the property. On the valuation issue, the Tax Court noted that Champion was correct in claiming that the IRS had undervalued the easement, and that the IRS was correct that Champion had overvalued the easement. Thus, the IRS established that it was substantially justified in its position and Champion was not a prevailing party.

An Easement is Not Worth More than the Underlying Property

Oconee Landing Property, LLC, et al. v. Comm'r, TC Memo 2024-25 (Feb. 21, 2024)

IRS guidelines make it clear that a conservation easement's value is the value of the forfeited development rights based on the land's highest and best use. To qualify as a highest and best use, a use must satisfy the following four criteria.

1. The land must be able to accommodate the size and shape of the ideal improvement.
2. A property use must be either currently allowable or most probably allowable under applicable laws and regulations.
3. A property must be able to generate sufficient income to support the use for which it was designed.
4. The selected use must yield the highest value among the possible uses.

> **Note.** A tract's highest and best use is merely a factor in determining FMV. It does not override the standard IRS valuation approach — the FMV is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts.[297]

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294. *Champion's Retreat Golf Founders, LLC v. Comm'r*, 959 F.3d 1033 (11th Cir. 2020), *rev'g and rem'g* TC Memo 2018-146 (Sep. 18, 2018).
295. *Champion's Retreat Golf Founders, LLC v. Comm'r,* TC Memo 2022-106 (Oct. 17, 2022).
296. IRC §7430(c)(4)(B).
297. See, e.g., Treas. Reg. §1.170A-1(c)(2). See also *Boltar LLC v. Comm'r*, 136 TC 326 (2011).

Oconee Landing Property donated 355 acres of undeveloped land to a land trust. The 355-acre tract was part of a larger tract that was a nationally recognized golf resort with associated developments. When the larger tract was not sold, Oconee became interested in the possibility of granting a conservation easement on the 355 acres. Ultimately, Oconee valued the 355 acres at about $60,000 per acre and claimed a charitable deduction for the entire amount — $20.67 million. The IRS disallowed the deduction due to **lack of donative intent** — the entire scheme involved a predetermined agreement to secure inflated appraisals so that investors would be able to deduct more than their respective investments.

> **Note.** The amount of the deduction that can be claimed is subject to a limitation based on a percentage of the taxpayer's contribution base.[298] However, if the donor is a **qualified farmer or rancher** and the donated property is used in agricultural or livestock production, the deduction may be up to 100% of the donor's contribution base.[299]

While the Tax Court determined that the donated easement had value, it agreed with the IRS that the value of the tract was approximately $5 million. However, Oconee forfeited any associated deduction because it failed to attach a qualified appraisal to its return, as regulations require. An appraisal does not meet the standard of "qualified" if the taxpayer merely sets a target value for the appraiser to reach. This is especially true when Oconee is aware that the target value is overstated.

> **Note.** Form 8283, *Noncash Charitable Contributions,* Section B, states an appraisal summary must be fully completed and attached to the return for noncash donations greater than $5,000.[300]

D

Section B. Donated Property Over $5,000 (Except Publicly Traded Securities, Vehicles, Intellectual Property or Inventory Reportable in Section A)—Complete this section for one item (or a group of similar items) for which you claimed a deduction of more than $5,000 per item or group (except contributions reportable in Section A). Provide a separate form for each item donated unless it is part of a group of similar items. A qualified appraisal is required for items reportable in Section B and in certain cases must be attached. See instructions.

Part I Information on Donated Property

2 Check the box that describes the type of property donated. See instructions for definitions.

- **a** ☐ Art (contribution of $20,000 or more)
- **b** ☐ Qualified conservation contribution
- **b(1)** ☐ Certified historic structure NPS # ____________
- **c** ☐ Art (contribution of less than $20,000)
- **d** ☐ Other real estate
- **e** ☐ Equipment
- **f** ☐ Securities
- **g** ☐ Collectibles
- **h** ☐ Intellectual property
- **i** ☐ Vehicles
- **j** ☐ Clothing and household items
- **k** ☐ Digital assets
- **l** ☐ Other

3	**(a)** Description of donated property (if you need more space, attach a separate statement)	**(b)** If any tangible personal property or real property was donated, give a brief summary of the overall physical condition of the property at the time of the gift.	**(c)** Appraised fair market value
A			
B			
C			

	(d) Date acquired by donor (mo., yr.)	**(e)** How acquired by donor	**(f)** Donor's cost or adjusted basis	**(g)** For bargain sales, enter amount received	**(h)** Qualified conservation contribution relevant basis (see instructions)	**(i)** Amount claimed as a deduction (see instructions)
A						
B						
C						

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 62299J Form **8283** (Rev. 12-2023)

298. IRC §170(b)(1)(H).

299. IRC §170(b)(1)(E)(iv). For corporate farms and ranches, see IRC §170(b)(2)(B), and for the definition of a "qualified farmer or rancher," see IRC §170(b)(1)(E)(v) and *Rutkoske v. Comm'r*, 149 TC 133 (2017).

300. IRC §170(f)(11)(c).

In addition, the Tax Court pointed out that the 355-acre tract had been transferred to a developer (a partnership) which then donated the easement. That meant that the donation was of ordinary income property which limited any deduction to the basis in the property. Because there was no evidence offered as to the basis of the property, the deduction was zero.[301]

The Tax Court added a gross overstatement penalty of 40%. In determining the penalty, the Tax Court agreed with the IRS's position that the highest and best use of the tract was as a "speculative hold for mixed-use development" and the easement was worth less than $5 million. The Tax Court also added a 20% penalty on the portion of the underpayment that was not associated with the erroneous valuation.

> **Note.** The rules associated with donated conservation easements are technical and must be followed precisely. While large tax savings can be achieved by donating a permanent conservation easement (especially for farmers and ranchers), carefully following all of the rules is critical. Predetermining a valuation is a big "no-no."

Conservation Easement Regulation Invalidated

Valley Park Ranch, LLC v. Comm'r, 162 TC No. 6 (Mar. 28, 2024)

Valley Park Ranch claimed a charitable deduction for a donated conservation easement. The easement deed stated that, if the conservation restriction ended, the donee would receive a certain monetary amount. This amount would be determined by a court unless prevented by state or federal law. If the government exercised eminent domain, the donee would receive its respective share of the proceeds based on a **qualified appraisal.** The IRS claimed that the deed language failed to satisfy the requirements of §170(h) and Treas. Reg. §1.170A-14(g)(6)(ii). Valley Park claimed that the regulation was invalid under the Administrative Procedure Act (APA). Following *Hewitt v. Comm'r,*[302] the Tax Court held that Treas. Reg. §1.170A-14(g)(6)(ii) is procedurally invalid under the APA and that the deed therefore need not comply with its requirements. The Tax Court also concluded that to the extent *Oakbrook Land Holdings, LLC,*[303] holds otherwise, the Tax Court will no longer follow it. The court also held the easement deed satisfies the **restriction (granted in perpetuity)** requirement under §170(h)(2)(C) and the **protected in perpetuity** requirement of §170(h)(5).

> **Note.** In *Cox Point Propco, LLC v. Comm'r*,[304] the Tax Court denied the IRS's motion for partial summary judgment that the petitioner's deed of easement regarding extinguishment proceeds failed to satisfy Treas. Reg. §1.170A-14(g)(6)(ii), because the regulation had previously been ruled invalid in *Valley Park Ranch*.

301. IRC §170(e)(1)(A).
302. *Hewitt v. Comm'r,* 21 F.4th 1336 (11th Cir. 2021), *rev'g and rem'g,* TC Memo 2020-89 (Jun. 17, 2020).
303. *Oakbrook Land Holdings, LLC v. Comm'r,* 154 TC 180 (2020), *aff'd* 28 F.4th 700 (6th Cir. 2022).
304. *Cox Point Propco, LLC v. Comm'r,* No. 16731-19, 2024 U.S. Tax Ct. LEXIS 1009 (U.S Tax Ct. Apr. 22, 2024).

> **Note.** In *Buckelew Farm, LLC v. Comm'r,*[305] the IRS disallowed the petitioner's charitable contribution deduction for a perpetual conservation easement based on the failure to meet the perpetuity requirement, and imposed penalties. The Tax Court allowed the deduction on the basis that the statutory requirements for a deduction had been satisfied and because the conservation purpose not being protected in perpetuity as required by Treas. Reg. §1.170A-14(g)(6)(ii) was not relevant. The court was bound to follow *Hewitt v. Comm'r,*[306] which invalidated the regulation in the Eleventh Circuit. However, the Tax Court held that the amount of the allowable charitable contribution deduction under §170 was the difference between the before and after value of the property, which was substantially less than the claimed deduction. The Tax Court determined that while a civil fraud penalty was not warranted, a penalty under IRC §6662 was warranted due to the gross valuation misstatement for the property.

Final Regulations on Donated Conservation Easements by Partnerships and Corporations

TD 9999 (Jun. 24, 2024), effective Jun. 28, 2022, for donations after Dec. 29, 2022

These final regulations implement provisions of the Setting Every Community Up for Retirement Enhancement (SECURE) 2.0 Act[307] that added §170(h)(7) which disallows a conservation contribution if the amount exceeds 2.5 times the sum of each partner's or shareholder's relevant basis in a partnership or S corporation. The final regulations provide guidance on the disallowance rule, including definitions, methods for calculating relevant basis, and reporting requirements. The final regulations also provide for reporting requirements for partners and shareholders that receive a distributive or pro rata share of any noncash charitable contribution made by a partnership or S corporation, regardless of whether the contribution is a qualified conservation contribution and whether or not the contribution involves real property.

SE Tax and Limited Partners

"Functional Analysis" Test

Soroban Capital Partners LP v. Comm'r, 161 TC No. 12 (Nov. 28, 2023)

A question in SE tax planning is whether an LLC member is a limited partner. In 1997, the Treasury issued a proposed treasury regulation[308] to address the issue, but it has never been finalized. The regulation establishes a fact-based analysis based on participation in management to determine limited partner status. **A limited partner does not participate in management.** For businesses other than those providing professional services, characterization of an LLC member's interest is determinative of whether the member has SE tax liability on amounts distributed to the member (other than guaranteed payments). That means that proper structuring of the entity matters, as does the drafting of the LLC operating agreement and the conduct of the members.

Here, the U.S. Tax Court issued a fully reported opinion confirming that state law classifications of a partner's interest is **not conclusive** on the SE tax issue. Soroban excluded distributions of ordinary income to its limited partners from its computation of net earnings from self-employment. Its basis for doing so was that the limited partners' interests conformed to state law. The IRS disagreed, asserting this was an insufficient reason, and that the functions and roles of the limited partners also had to be analyzed for SE tax purposes. The Tax Court agreed with the IRS.

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305. *Buckelew Farm, LLC v. Comm'r,* TC Memo 2024-52 (Apr. 25, 2024).

306. *Hewitt v. Comm'r,* 21 F.4th 1336 (11th Cir. 2021), *rev'g and rem'g,* TC Memo 2020-89 (Jun. 17, 2020).

307. *SECURE 2.0 Act,* PL 117-328.

308. Prop. Treas. Reg. §1.1402(a)-2.

At issue was the definition of a **limited partner** for purpose of the exception from SE tax under §1402(a)(13). The Tax Court noted that the proposed regulations provided a definition and that Congress froze the finalization of the regulation for six months and has said very little about the issue since the freeze was lifted and has not provided a definition. The Tax Court noted that it had applied a **functional analysis test** in *Renkemeyer, Campbell, & Weaver, LLP,*[309] but this was the first time the Tax Court was asked to determine the SE tax status of limited partner in a state law limited partnership (having passed on the issue in a 2020 case).

The Tax Court determined that the functional analysis test applied based largely on statutory construction of §1402(a)(13), which excludes from SE tax "the distributive share of any item of income or loss of a limited partner, as such." The court concluded that the "as such" language meant that there was not a blanket exclusion for a limited partner. Instead, the statute only applies to a limited partner who is acting as a limited partner. If a limited partner is anything more than merely an investor, SE tax applies to the partner's distributive share.

> **Note.** The Tax Court noted that Soroban cited legislative history to support its position, but that the legislative history actually supported the position of the IRS. The Tax Court also noted that Soroban put forth numerous additional arguments, none of which were persuasive. Soroban even cited language in the instructions for Form 1065 which it claimed defined a limited partner, but the Tax Court noted that the definition did not purport to define a limited partner.

The Tax Court held that a functional inquiry into the roles and activities of Soroban's individual partners under §1402(a)(13) "involves factual determinations that are necessary to determine Soroban's aggregate amount of net earnings from self-employment." Accordingly, the Tax Court denied Soroban's motion for summary judgment and set forth the rule going forward in evaluating the application of SE tax for limited partners in professional service businesses.

> **Note.** The manager-managed LLC provides a better result than the result produced by the member-managed LLC for LLCs that are not service partnerships. For those that are, an S corporation is the most appropriate business form to achieve a better tax result. For an S corporation, reasonable compensation will need to be paid subject to SE tax, but the remaining taxable income from the entity can be received free from SE tax. However, for farming operations with land rental income, the manager-managed LLC can provide a better overall tax result than an S corporation because of the ability to eliminate the NIIT.

> **Observation.** With this decision, the Tax Court has laid down the rule in a precedential opinion that it is not enough to simply hold a limited partnership interest under state law (in the context of a professional service business). A limited partner must truly be acting as an investor and no more. Based on *Soroban*, the parties in *Sirius Solutions, LLLP v. Comm'r,*[310] stipulated that the functional analysis test dictated that the taxpayer's "state-law" limited partners are not "limited partners, as such for purposes of IRC §1402(a)" and that their distributive shares of ordinary business income are part of net earnings from self-employment.

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309. *Renkemeyer, Campbell, & Weaver, LLP v. Comm'r,* 136 TC 137 (2011).

310. *Sirius Solutions, LLLP v. Comm'r,* No. 30118-21, 2024 U.S. Tax Ct. LEXIS 420 (Feb. 20, 2024).

Hobby Loss

Horse Farm Not Operated for Profit

Skolnick v. Comm'r, 62 F.4th 95 (3d Cir. 2023), *aff'g* TC Memo 2021-139 (Dec. 16, 2021)

The Skolnicks jointly owned horse farms with others. Their company had between seven and 10 employees. Between 1998 and 2013, the Skolnicks lost more than $11.4 million, and for the years under examination (2010–2013), they lost $3.5 million. The Tax Court determined that the activity was not engaged in with a profit intent based on the nine factors in the regulations under IRC §183. Of those factors, the Tax Court determined that the magnitude of the losses was the strongest factor that favored the IRS and that only one factor favored the petitioners — their expertise about horses. The Skolnicks' company also spent funds on items that were personal, including a wedding for one of the owners. The appellate court affirmed.

Farming Activity not Engaged in for Profit, but No Accuracy-Related Penalty

Schwarz v. Comm'r, TC Memo 2024-55 (May 13, 2024)

The Schwarzes had a history of conducting real estate-related activities involving ranchland. Through their controlled entities, the Schwarzes bought 15,070 acres in 2005 with the intent to improve it and sell it. However, they later decided to establish an ecotourism activity on a portion of the land involving fee-based fishing and hunting and other outdoor events. That activity was conducted by a partnership that they owned, which leased the land from their other controlled entities. The partnership also conducted farming and construction operations on the land and other properties that they owned. The partnership filed a Schedule F for every year from 2005 to 2020, reporting income from both the ecotourism activity and the farming/construction operations. The Schedule F gross income reported for those years exceeded $14 million, but resulted in a reported net loss every year. The losses flowed through to the Schwarzes, which offset significant taxable income.

The IRS issued a notice of deficiency for tax years 2015–2017, determining that the partnership's activity was not engaged in with the requisite profit intent under §183. The IRS also applied a 20% accuracy-related penalty for each year. The Schwarzes claimed that they were engaged in the Schedule F activity with a profit intent and that the real estate and the partnership's (and related entities' activities) were engaged in a single activity.

The Tax Court determined that the Schedule F activity and the real estate activities were separate and that the Schedule F activity was not engaged in with the intent to make a profit. On whether the activities were separate or should be combined, the Tax Court noted that the factors of Treas. Reg. §1.183-1(d)(1) (which establishes a test for treating farming and the holding of land on which farming occurs as one activity) were relevant and that neither party "came even remotely close to adequately addressing the issue." The Tax Court rejected the Schwarzes' argument that the regulation was inapplicable because the farming expenses contributed to the appreciation of the real estate. The Tax Court held that no such exception applied and that the factors set forth in the regulation and caselaw favored the IRS.

On the profit intent issue, the Tax Court went through the factors of Treas. Reg. §1.183-2(b) and concluded that most of the factors favored the IRS, particularly noting the long history of losses and lack of profit only permissible by the Schwarzes' high non-farm income, particularly when the real estate market was strong. Accordingly, the Tax Court determined that the Schwarzes were not engaged in the farming activity with the intent to make a profit.

As for the accuracy-related penalties, the Tax Court noted that the Schwarzes' CPA advised them during the tax years in issue and they relied in good faith on him as an experienced CPA. As such, the Tax Court held that the accuracy-related penalties did not apply for the tax years at issue.

Note. This case involved large-scale revenues and losses associated with activities regarding the petitioners' personal interests who also had high income derived from other sources. The petitioners' books and records were inadequate and their business plans were not well developed. The lawyering in the case was also deficient. Indeed, the Tax Court stated:

> *Many facts stipulated, alleged, argued, testified about, and otherwise presented to the Court in this case are, or appear to be, incorrect or misleading. The parties' work occasionally reflected an uninspired attitude toward developing, trying, and briefing this case. As a result, many potentially relevant facts and arguments were undeveloped, ignored, misrepresented, and/or missed.*

The Tax Court was also critical of the credibility of expert witness reports offered in the case, as well of the credibility of the petitioners. This case illustrates the responsibility of legal counsel to candidly assess credibility of both their clients and their expert witnesses.

Tax Litigation and Procedure

Damages Awarded for False Filing of Form 1099-Misc

Scot Thompson Farms, LLC v. Hap Holdings Trust, No 8:23CV25, 2023 U.S. Dist. LEXIS 107772 (D. Neb. Jun. 21, 2023), *appeal filed,* No. 23-2712 (8th Cir. Jul. 26, 2023)

Scot Thompson Farms received Forms 1099-MISC reporting more than $15 million in connection with land it had acquired from Hap Holdings Trust (a trust) in a court-ordered sale. The Hap Holdings Trust's trustee, Jan Mengedoht, apparently retaliated by submitting these false documents to the IRS. The stated amounts were based on "100 years' use of both wind and solar energy easements," "29 years of the settlor's wages," and "involuntary conversion of the land."

The court found a basis for relief under IRC §7434 that each of the four Forms 1099-MISC should reflect payments of $0 and imposed a statutory damage award of $5,000 for each of the four false Forms 1099-MISC. No attorney fee award was mentioned in the court's order.