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## CPA's guide to saving tax dollars for farm clients;

Andrew R. Biebl

Robert J. Ranweiler

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

# **A CPA's Guide to Saving Tax Dollars for Farm Clients**

**Andrew R. Biebl, CPA  
and  
Robert J. Ranweiler, CPA**

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## Notice to Readers

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## FOREWORD

In this book, two highly respected authors with years of experience serving agricultural clients have teamed up to produce a book that's a must for any CPA who needs to know the "ins and outs" of taxation in the farm industry.

*A CPA's Guide to Saving Tax Dollars for Farm Clients* thoroughly examines five areas of critical importance to farmers and others engaged in the business of farming. You will find key, up-to-the-minute tax planning strategies that can produce big savings for clients. The text is concise and on-target.

We would like to thank Andrew R. Biebl, CPA and Robert J. Ranweiler, CPA of Biebl, Ranweiler, Christiansen, Meyer, Thompson & Company, CHTD, of New Ulm, Minnesota, for writing this book.

We would also like to thank Alvin J. Geske, Esq., of Sills & Brodsky, P.C., Washington, D.C., for his careful technical review of the course on which this book is based.

Mary Schantz  
Vice President, Product Development

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# CHAPTER 1

## KEY INCOME ISSUES

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### OVERVIEW

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An understanding of this chapter will enable you to:

- Identify the various accounting methods available to farmers;
- Identify the requirements and methods of valuing inventories;
- Identify when to elect the deferral rules relating to hail and crop insurance proceeds and livestock sales due to drought;
- Identify the methods for reporting Commodity Credit Corporation loans;
- Determine the correct reporting rules for the sale of livestock;
- Understand and apply the patronage dividend/per-unit retains rules; and
- Understand the new income-averaging rules applicable to farmers for 1998, 1999, and 2000.

### INTRODUCTION

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Taxpayers classified as farmers enjoy many unique opportunities for raising or lowering taxable income. Often, taxable income as reported on Schedule F has little resemblance to a farmer's economic income or even cash flow.

The calculation of Schedule F farm income involves a number of special rules affecting the character, taxable amount, and timing of reporting the income. This chapter surveys those special rules, and also explains the unique business transactions, such as Commodity Credit Corporation loans and patronage income, which apply to farmers. For the 1998, 1999, and 2000 tax years, farmers are permitted to use a special form of income averaging, which we will discuss briefly.

### METHOD OF ACCOUNTING

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An accounting method must be chosen on the first Schedule F filed for the farm or ranch operation. The method is elected by the manner in which income and expense are reported in the taxpayer's initial farm return, and is disclosed by completing the appropriate box at line C near the top of Schedule F.

## Cash Method

The *cash method* is used most frequently because of its simplicity and ability to manipulate taxable income. Income is reported in the year cash is received or made available. Expenses are deductible in the year paid [IRS Pub. 225, *Farmer's Tax Guide*, Ch. 3 and Reg. Secs. 1.61-4(a) and 1.461-1(a)(1)]. Under the doctrine of constructive receipt, income must be reported in the taxable year that the income is:

- Credited to the recipient's account;
- Set apart for the recipient;
- Made available to the recipient so that it can be drawn upon at any time; or
- Made available so that the recipient could have drawn upon it if notice of intention to withdraw had been given by the recipient [Reg. Sec. 1.451-2(a)].

See Chapter 3 for a further discussion on the doctrine of constructive receipt, as well as income recognition under deferred and price-later commodity contracts.

The availability of the cash method of accounting for farmers is a distinct exception to the general rule requiring all taxpayers who sell merchandise or goods to use the accrual method. Regulation Sections 1.471-1 and 1.446-1 force all other taxpayers who produce or sell goods in amounts materially affecting their income to report under accrual accounting.

Crop shares received by a cash method farm landlord are included in gross income only when converted to money or the equivalent of money [Reg. Sec. 1.61-4(a)].

**Definition of "Farming" for Accounting Method Purposes.** A farm includes stock, dairy, poultry, fish, fruit and truck farms, and plantations, ranches, ranges, orchards and all land used for farming operations [Reg. Secs. 1.61-4(d) and 1.175-3].

The farm accounting methods are available for all taxpayers, whether operating as individuals, partnerships or corporations except for limited classes of corporations, partnerships, farm syndicates, and tax shelters required to use the accrual accounting method as described below [IRC Sec. 447].

The business of farming involves cultivating, operating or managing a farm for profit, either as an owner or tenant.

Exclusions from definition of farming:

- Taxpayers engaged in forestry or the growing of timber.
- Persons operating a farm for recreation or pleasure rather than profit [Reg. Sec. 1.175-3].

**Court Decisions.** Who is a farmer qualifying for the cash method:

- A hatchery operator was determined to be a farmer [*Chemell*, 243 F2d 944, CA-5 (1957)].

- An incorporated cattle feedlot was held to be a cash method farmer, despite some feed sales to customers [*Hi-Plain Enterprises, Inc.*, 60 TC 158 (1973); affirmed 496 F2d 520, CA-10 (1974)].
- A frozen food processing corporation was allowed the use of the cash method because its raising of ducks qualified it as a farmer [*Maple Leaf Farms, Inc.*, 64 TC 438 (1975)]. The court applied a two part test to define a farmer:
  - Participating to a significant degree in the growing process; and
  - Bearing a substantial risk of loss from that process. (See also *Daniel Cameron*, 43 TCM 1341 (1982).)

### Accrual Method

Under the *accrual method*, income is reported in the year earned.

Income is reportable at the time that all events which fix the right to receive income have occurred and the amount is reasonably determinable. Expenses are deductible in the year the farmer/rancher becomes liable for the expense and economic performance has occurred.

Inventories must be considered. Increases or decreases in inventory *values* at year-end are reflected in gross income. Therefore, changes in market prices used to value inventory affect gross income. See page 6, Reporting of Inventories, for a discussion of this topic.

The accrual method is the most accurate method of matching income and expenses in the same crop year, but provides fewer opportunities to affect taxable income.

The accrual method is favored by some farm managers and analysts because it provides a more accurate picture of the economic success of the operation. However, because raised commodities are generally reflected in inventory at market value, the accrual method can lead to large swings in income from year to year. This occurs because of fluctuations in commodity prices, and also variations in ending inventory quantities (occurring due to influences of weather, disease, government agricultural programs, etc.). Conversely, farmers reporting on the cash method will generally adjust their collections on sales of commodities, as well as payments for inputs, so as to report a more stable amount of annual taxable income.

*Practice Tip:* One technique to convert an accrual method farmer to the cash method of accounting is to incorporate the entity, allowing a new accounting method (i.e., cash method) to be adopted in the new incorporated entity.

A farmer is permitted to use the accrual method in books and records maintained for management or lender purposes, but file for income tax purposes under the cash method. Despite a statutory requirement that the accounting method in the tax return conform to the taxpayer's books and records [Sec. 446(a)], the IRS has allowed accrual-to-cash reconciling entries and accountant workpapers to be considered the books and records for this conformity rule [Rev. Rul. 68-35, 1968-1 CB 190; Rev. Rul. 68-83, 1968-1 CB 190; TAM 9103001].

If a taxpayer has two or more distinct businesses, such as a farm and nonfarm activity, different accounting methods may be used for each, provided that separate books and records are maintained [Reg. Sec. 1.446-1(d)].

#### Example 1-1

Van Carter is a cash method proprietor who operates a grain farm. At his farm site, Van also operates a farm equipment parts business (he purchases and resells sprayer parts).

Van reports his grain farming activities on Schedule F using the cash method, and reports his retail parts business under the accrual method on Schedule C.

**Mandatory Accrual Method: Corporations and Partnerships with a Corporate Partner [Sec. 447].** A corporation engaged in the business of farming, as well as a partnership engaged in the business of farming which has a corporate partner, is required to use the accrual method; however, this mandatory accrual rule does not apply to:

- An entity operating a nursery or sod farm, or raising or harvesting trees (other than fruit and nut trees) [Sec. 447(a)];
- An S corporation;
- A corporation whose gross receipts for each tax year beginning after 1975 are \$1 million or less (with a controlled group treated as one corporation); or
- A family-controlled corporation or corporate group whose gross receipts for each tax year beginning after 1985 are \$25 million or less [Sec. 447(c)].

A *family corporation* is generally defined as having at least 50% of all classes of stock owned by members of the same family. See Section 447(e) for the definition of family members, and Section 447(h) for expanded family corporation definitions allowing certain two- and three-family corporations to retain the cash method.

**Mandatory Accrual Method: Farming Syndicates and Tax Shelters [Sec. 448].** Use of the cash method of accounting is prohibited for farming syndicates and tax shelters.

A farming syndicate is a partnership, an S corporation, or any other noncorporate entity engaged in farming if:

- Ownership interests in the entity were ever offered for sale in any offering requiring registration with any federal or state agency regulating securities sales; or
- More than 35% of the losses during any period are allocable to limited partners or limited entrepreneurs (limited entrepreneurs are those other than limited partners who do not actively participate in management) [Sec. 464(c)].

A tax shelter is defined as:

- A partnership or other entity;
- Any investment plan or arrangement; or



- Any other plan or arrangement if the principal purpose of the partnership, entity or arrangement is the avoidance or evasion of federal income tax [Sec. 6662(d)(2)(C)(ii), via cross-reference from Secs. 448(d)(3) and 461(i)(4)].

### **Crop Method**

A third method of accounting available to farmers, the crop method, defers all costs and deductions relating to production of the crop, including the cost of seed or young plants, until the year income from the crop is realized. This method can only be used by farmers who do not complete harvesting and disposing of their crop in the year planted [Reg. Secs. 1.61-4(c) and 1.162-12(a)].

Although the crop method is available for other products, its historical use has primarily been with pineapple and sugar cane farms. In general, the crop method appears to have little attraction for the traditional grain farmer, due to the requirement that all costs be deferred until the year of income recognition.

Prior IRS consent is required to use the crop method, even if selected for the initial year of farming [Reg. Sec. 1.446-1(e)(2)(ii)(a)]. To request approval, Form 3115 is to be submitted to the IRS [Reg. Sec. 1.446-1(e)(3)].

### **Hybrid Methods**

Any combination of the cash and accrual methods which clearly reflects income and is used consistently is permitted [Reg. Sec. 1.446-1(c)(iv)]. The following restrictions apply:

- A taxpayer using the cash method to compute gross income must use the cash method for reporting expenses; and
- Similarly, a taxpayer using the accrual method for reporting expenses must use the accrual method in computing gross income.

In general, the most common hybrid method would be use of the accrual method with respect to purchases and sales, and use of the cash method for all other items of income and expense.

### **Change in Accounting Method**

Once an accounting method has been adopted, approval must be obtained from the IRS in order to change methods. Form 3115, "Application for Change in Accounting Method," must be filed to request the change [Reg. Sec. 1.446-1(e)]. Form 3115 is also used to change from an improper to a proper accounting method [Rev. Proc. 97-27, IRB No. 1997-21].

## REPORTING OF INVENTORIES

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### Accrual Method

A farmer using the accrual method of accounting must include inventories in calculating gross income [Reg. Sec. 1.61-4(b)]. Unharvested or growing crops are generally not included in inventory, unless the crop's preproductive period is greater than 2 years. The IRS briefly attempted to require inventory valuation of growing farm and nursery crops in Revenue Ruling 76-242, but Congressional action in the 1978 Revenue Act caused reversal of this position [Rev. Rul. 79-102, 1979-1 CB 184].

Similarly, the 1986 Tax Reform Act imposed the Section 263A uniform capitalization rules on plants and animals with a preproductive period exceeding two years, but 1988 legislation repealed these capitalization requirements for any animal produced in a farming business. As a result, uniform capitalization of preproductive period expense is only required in the infrequent case of plants with a preproductive period exceeding two years, and where the producer does not make an election to avoid the capitalization (see IRS Pub. 225, Ch. 7).

Those corporations, partnerships, or tax shelters required to use the accrual method of accounting do not have available either the exception for preproductive periods under two years, or the ability to elect to avoid capitalization.

For capitalization under Section 263A of costs associated with growing crops having a preproductive period of over 2 years, read below.

**Inventory Valuation Methods.** There are four methods identified in the regulations which are available to accrual-method farmers for valuing harvested commodities or livestock:

- Cost method [Reg. Sec. 1.471-3].
  - Animals purchased after maturity are inventoried at their purchased price.
  - Additional expenditures that increase the value of immature livestock and purchased crops are to be added to the cost. Examples include feed, direct labor and attributable indirect costs [Rev. Rul. 55-736, 1955-2 CB 522; IRS Pub. 225, Ch. 3].
- Lower of cost or market [Reg. Sec. 1.471-4].
  - The market value of each item on hand at the inventory date is compared to the cost, and the lower value is used. The comparison occurs for each item separately, rather than for the entire inventory.
  - The Tax Court, in allowing a modified FIFO method, specifically approved the lower of cost-or-market method for a farmer [*S. Weisbart*, TC Memo 1964-130].
- Farm-price method [Reg. Sec. 1.471-6(d)].
  - Inventories are valued at market price less direct cost of disposition (i.e., net realizable value). Costs of disposition include sales commissions, trucking and freight, and other marketing costs.

- If the farm-price method is used, it must be applied to the entire inventory, except any livestock valued under the “unit-livestock-price method.”
- The farm-price method has the advantage of simplicity compared to the two previously discussed methods, as it is not necessary to maintain detailed cost records. However, use of market values accelerates the reporting of taxable income, and swings in commodity market prices can lead to further income fluctuations.
- Unit-livestock-price method [Reg. Sec. 1.471-6(e)].
  - Livestock is classified according to age and kind (e.g., yearling bull calves), and a standard unit price, representing the approximate cost of production, is applied to each animal within the class. The unit price is to account for raising an animal only to maturity; increases in cost after maturity and any decreases in value are ignored.
  - Once established, the unit prices and classes can only be changed with IRS consent.
  - Raised livestock: Must be included in inventory, regardless of whether held for sale, or for draft, breeding, dairy or sporting purposes. Costs of productive animals are held until sale or death and then deducted from inventory; depreciation is not claimed. This is contrary to rules for accrual farmers valuing productive livestock under the cost, lower of cost or market, or farm-price method; under those three methods mature raised animals placed into productive use may be depreciated [Reg. Sec. 1.61-4(b)].
  - Purchased livestock: Must be treated as inventory if the animals are purchased for resale. However, animals purchased for draft, dairy, or breeding purposes can, at the election of the taxpayer, be included in inventory or placed in depreciation at maturity. A consistent approach must be followed from year to year [Reg. Sec. 1.471-6(g)].

### Cash Method

Taxpayers on the cash method of accounting can ignore the costs of raised commodity inventory in calculating gross income. However, the costs of purchased inventory held for resale cannot be deducted as an expense until the sale occurs [Reg. Sec. 1.61-4(a)]. The cost of purchased commodities held for resale should include freight charges for transportation to the farm. Seeds or young plants purchased for further development prior to sale (other than with Christmas trees, orchards and timber) may be deducted as an expense when paid.

#### Example 1-2

Gene, a hog farmer who purchases and raises feeder pigs, buys 100 feeder pigs on September 12 for \$5,000 (\$50 per head). On December 21 of the same year, Gene sells 30 of the feeder pigs he purchased on September 12.

Gene may deduct \$1,500 of cost against the pigs sold (30 head at \$50 cost per head). The remaining 70 head (cost of \$3,500) become deductible in the year the hogs are sold.

Also, the purchase price of hens bought for commercial egg production and baby chicks bought for raising and resale may be deducted as an expense by a farmer on the cash method of accounting in the year the costs are paid. This practice must be consistently applied and clearly reflect income [Rev. Rul. 60-191, 1960-1 CB 78].

It is important to recognize that a cash method farmer who purchases a commodity for resale, and is required to defer the deduction for the cost until year of sale, is not operating under any of the inventory rules of the Internal Revenue Code. The deferral of purchased costs for resale is required by the special cash method farm rules of Regulation Section 1.61-4. This does not entitle the cash method farmer to use LIFO, FIFO or any such rules which apply to inventory accounting methods [Rev. Rul. 88-60, 1988-2 CB 30].

**Exception for Damaged Crops.** Even though all plants with a preproductive period of more than two years are subject to capitalization, an exception exists for the costs of replanting caused by loss or damage due to freezing, disease, drought, pests or casualty. The plants must bear an edible crop for human consumption. The replanting may occur on either the same parcel of land on which the lost or damaged plants were located, or on any other parcel of land of the same acreage within the U.S. [Sec. 263A(d)(2)].

#### **Example 1-3**

In 1998, Michael, a citrus grove operator, had 40% of his groves permanently damaged due to a freeze. Michael replanted the damaged trees, incurring considerable cost.

Under Section 263A(d)(2), Michael will be able to deduct the replanting costs in 1998. However, any costs relating to the inception of a new grove (not due to the freeze) must be capitalized because the preproductive period of the trees is over two years.

**Special Rule for Citrus and Almond Growers.** The election to avoid preproductive period capitalization under Section 263A(d)(3) continues to be available to any first year farmer who becomes involved in raising plants with a preproductive period of more than two years.

However, the election to avoid preproductive period capitalization does not apply to any costs incurred for the planting, cultivation, maintenance or development of any citrus or almond grove, or any portion of such a grove, within the first four years that the trees were planted. If a citrus or almond grove is planted over several years, the part of the grove planted in any one year is treated as a separate grove for purposes of the four-year rule [Sec. 263A(d)(3)(C)].

## **CROP INSURANCE PROCEEDS**

Generally, payments received from insurance carriers covering destruction of crops due to natural disasters must be included as income in the year received. Taxpayers who report on the cash method may elect to postpone reporting insurance proceeds from the year of damage to the following year if the proceeds are received in the year of damage [Sec. 451(d) and Reg. Sec. 1.451-6]. The following criteria must be met in order to postpone reporting the proceeds as income:

- Taxpayer must be on the cash method of accounting.
- The taxpayer's normal business practice would have been to report the income from the damaged crop in any year following the damage or destruction.
- A statement in support of the election to postpone reporting must be attached to Form 1040 in the year the damage occurred. Merely indicating on the return that the proceeds are being deferred does not constitute an election [IRS Pub. 225, Ch. 4].

The election statement to postpone reporting must contain

- A statement that the election is made under Section 451(d) of the Internal Revenue Code and Regulation Section 1.451-6 of the Income Tax Regulations;
- The specific crop or crops destroyed or damaged;
- A statement that under normal business practice the farmer would have included income derived from the destroyed or damaged crops in gross income for a tax year following the tax year of the destruction or damage;
- The cause of the destruction or damage and the date or dates it occurred;
- The total amount of payments received, itemized for each specific crop, and the date each payment was received; and
- The name of the payer or payers from whom payments were received [IRS Pub. 225, Ch. 4; Reg. Sec. 1.451-6(b)(1)].

The election to defer insurance proceeds can be made in either an original *or amended* return. See page 28 for a sample election statement.

An election made for a particular tax year is binding, unless the District Director consents to a change requested in writing by the taxpayer. The decision to defer or not to defer crop insurance proceeds, however, is made independently for each year that insurance is received [Reg. Sec. 1.451-6(b)(2)].

In the case of a taxpayer receiving insurance proceeds from damage to two or more specific crops, an election to defer is deemed to cover all proceeds attributable to crops representing a single trade or business. However, if a taxpayer operates two separate farms and maintains separate books for each business, separate elections may be made for each business [Reg. Sec. 1.451-6(a)(2); IRS Pub. 225, Ch. 4].

#### **Example 1-4**

Mark Ryder is a cash method grain farmer who maintains a single set of books for his operation. Mark's entire corn and soybean crop was damaged due to drought, and he received insurance proceeds for both crops.

Mark cannot elect to defer the corn insurance proceeds and report the soybean proceeds as income (or vice versa). The election to defer must apply to all proceeds because Mark operates a single farming business.

Crop insurance proceeds, for purposes of the Section 451(d) deferral, include payments received from private carriers as well as government agricultural program disaster payments. These program payments are administered by the Agricultural Stabilization and Conservation Service (ASCS) of the U.S. Department of Agriculture.

Section 451(d) specifically allows deferral of payments received under the Agricultural Act of 1949 or the Disaster Act of 1988, Title II, as amended, as a result of damage or destruction to crops caused by flood, drought, any natural disaster or the inability to plant crops by reason of such disaster.

When the Disaster Assistance Act of 1989 provided an additional form of government disaster payment, the question arose as to whether these payments also qualified for Section 451(d) relief. The Treasury clarified this by issuing final Regulation Section 1.451-6 (T.D. 8429, 8/25/92), holding that all federal crop disaster program payments, if paid by reason of natural disaster, qualify for deferral. [See also Rev. Rul. 91-55, IRB No. 1991-43, p. 16.]

If an election is made to defer crop insurance proceeds, all current year eligible receipts, whether from private crop insurance or ASCS disaster programs, must be deferred [IRS Notice 89-55, 1989-1 CB 696].

*Practice Tips:*

- Preparers must be certain to flag in the client's file a reminder to report any deferred crop insurance proceeds as income in the following year.
- In the case of insurance carriers that allow deferral of the premium payment by the farmer until harvest time, the insurance proceeds issued to the farmer often are reduced by the unpaid premium. However, in making the deferral election, the gross proceeds are to be deferred, and the premium expense is allowed currently as a deduction. Matching the amount on the Form 1099 from the insurance carrier with the farm cash receipt records will assist the preparer in identifying this situation.

**Example 1-5**

Carl Corsoy is a wheat and soybean cash method farmer who suffers hail damage to his crops.

The insurance company determines that Carl is entitled to \$4,000 of crop insurance proceeds, but only issues a check for \$3,200 after reduction for the unpaid premium.

Carl should deduct the \$800 amount as an expense in the current year. If he elects to defer the crop insurance, the gross amount of \$4,000 is reported in the following tax year.

## COMMODITY CREDIT CORPORATION (CCC) LOANS

It is a common practice of farmers to pledge grain as collateral to secure a loan from the government-backed Commodity Credit Corporation (CCC). In doing so, farmers may establish a minimum price by forfeiting the grain should prices drop below the loan value and yet retain the

ability to market the grain later should the commodity price increase. Taxpayers may report the loan proceeds under one of two methods.

### Methods of Reporting CCC Loans

**Loan Method.** Cash received from the CCC is treated as a loan and not included in income. Income is recognized in the year the grain is sold or when the grain is forfeited to CCC.

If grain is forfeited to CCC in satisfaction of a loan liability, the taxpayer should receive a Form 1099-A from the U.S. Department of Agriculture (Form 1099-A is used to report the abandonment of property in satisfaction of debt). The loan forfeit amount is reported on line 7b of Schedule F, with the same amount entered as taxable income on line 7c.

*Caution:* The loan method often creates large amounts of income but no cash flow in the year the grain is sold and the loan is repaid.

#### Example 1-6

Farmer A seals \$30,000 of grain in 1997 and reports CCC loans on the loan method. In 1998, Farmer A pays off the loan and sells the grain.

In 1997, he would not report any income from this transaction. In 1998, Farmer A must report the grain sales as income. If he has used the original loan proceeds in 1997 to pay off other debt, purchase capital assets or pay expenses, he may lack the cash to pay the tax on the income in 1998.

**Income Method.** For a taxpayer who has made the Section 77 election, income is reported in the year grain is sealed (placed in storage and pledged to CCC as collateral for a loan). The amount reported is the cash proceeds of the CCC loan. The income recognized becomes the tax basis in the grain [Sec. 1016(a)(8)].

#### Example 1-7

Farmer B seals \$30,000 of corn with the CCC on March 1, 1997, and has previously made an election under Section 77 to report CCC loans as income.

On December 28, 1997, he "buys back" the grain (i.e., repays the \$30,000 loan), and on January 12, 1998 sells the grain for \$32,000.

The transactions are reported as follows:

	Debit	Credit
1) CCC loan on 3-1-97:		
Cash	\$30,000	
Loan Payable		\$30,000
Basis in corn	30,000	
Income – Sec. 77 election		30,000
2) Repay CCC loan on 12-28-97:		
Loan Payable	30,000	
Cash		30,000
3) Sell corn on 1-12-98:		
Cash	32,000	
Basis in corn		30,000
Income		2,000

*Practice Tip:* Many farmers, and even tax practitioners, fall into the trap of viewing CCC loan repayments (known as “buy-backs”) as an income tax expense. The repayment of the CCC loan, however, is of no income tax consequence, regardless of whether the taxpayer is on the Section 77 income method.

The farmer under the income method has tax basis in the grain as a result of the CCC loan; this tax basis must be held until the grain is sold if the grain is held for resale; however, if the grain is acquired for livestock feed when the CCC loan is removed, a feed expense deduction would be allowable.

Forfeiture of grain to CCC in repayment of a loan is a nontaxable event to the farmer on the income method. The basis in the grain is simply offset against the loan liability, although a gain or loss (reportable on Schedule F) would occur if the CCC loan liability is more or less than the basis in the grain.

**Electing the Income Method for CCC Loans.** No permission is required from the IRS to elect the income method. If electing the income method, the CCC loan proceeds for the year are included as income on line 7a of Schedule F.

The income election is considered the adoption of an accounting method and as such is binding on all future years [Reg. Sec. 1.77-1].

Both IRS Publication 225 and the Schedule F instructions indicate that an election statement is to be attached to the return in the year of adopting the income method, to report the following data:



- Amount of loan;
- Commodity; and
- Quantity in bushels.

Taxpayers using the loan method can change to the income method without IRS approval. The Section 77 income method election must be made in a timely filed return; it cannot be adopted via an amended return [Rev. Rul. 56-358, 1956-2 CB 99]. However, once the election to report CCC loans as income has been made, IRS consent must be obtained to change from the income method to the loan method.

Form 3115, "Application for Change in Accounting Method," must be filed with and approved by the IRS prior to any change from the income method to the loan method. A user fee must accompany this application [Reg. Sec. 1.77-1].

In the year of electing the income method, all CCC loans originating in the current year must be reported as income. The farmer is not permitted to adopt the income method at a point in time within a tax year [TAM 8819004]. For farmers who report on the income method, a CCC loan borrowed and repaid within the same year cannot be ignored [Rev. Rul. 80-19, 1980-1 CB 185]. (See Example 1-7, preceding, for an illustration of a CCC loan received and repaid within the same tax year.)

When a taxpayer changes CCC loan reporting methods, the new method applies only to current year and subsequent loans. Conceivably, a farmer can be reporting on two methods until prior loans are satisfied.

#### **Example 1-8**

Bob Young has reported his CCC loans on the loan method for many years. Going into 1998, Bob had a \$20,000 corn loan which originated in 1996.

In 1998, Bob decides he would like to change to the income method effective with 1998 loans. In 1998, Bob took out a \$15,000 soybean loan with CCC. Bob also paid off the 1996 corn loan and sold the corn for \$23,000 in 1998.

On his 1998 Schedule F, Bob should report grain sales of \$23,000 and CCC loan income of \$15,000.

*Practice Tip:* Under the income method, tax preparers must be sure to ask clients how they disposed of, or plan to dispose, of the grain. If fed, or held as inventory for feed, the grain is deductible in the year removed from the CCC storage lien (i.e., at repayment of the CCC loan). If the grain is held with the intention of selling it in a following year, the basis in the grain is held until the grain is actually sold.

Interest paid to CCC is deductible in the year paid regardless of which method is used.

## LIVESTOCK SALES DUE TO DROUGHT, FLOOD, OR OTHER WEATHER-RELATED CONDITIONS

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### Deferral of Gain

The gain from the sale of livestock sold early due to drought, flood, or other weather-related conditions may be deferred for one year [Sec. 451(e)]. (Before 1997, the deferral opportunity was available only for forced sales due to drought.)

The livestock can be either raised or purchased, and may be held either for resale or productive use (i.e., dairy, breeding, draft or sporting purposes). However, animals held for productive use may also be eligible for Section 1033 involuntary conversion treatment.

Only livestock in excess of the number which normally would have been sold under usual practices is treated as an involuntary conversion. The cost of replacement livestock is reduced by the gain from the involuntary conversion. The gain is deferred over the life of the replacement property through a lesser amount of depreciation expense on the replacement animals.

See Chapter 3 for a discussion on involuntary conversions.

The gain from the sale of livestock due to a drought, flood, or other weather conditions may be deferred if:

- The taxpayer's principal business is farming;
- The cash method of accounting is used;
- Under normal business practices, the sale would not have occurred in the current year except for the drought, flood, or other condition; and
- The drought, flood, or other condition resulted in an area designated as eligible for assistance by the federal government [Reg. Sec. 1.451-7].

The gain to be postponed is equal to the total income realized from the sale of all livestock divided by the total head sold, multiplied by the excess number of head sold because of the drought or other condition (number of head sold in current year less average head sold in three most recent years).

*Note:* The regulations do *not* mandate that the excess is to be determined based on the average sold in the most recent three years—this is merely an example, but is logical based on the fact that the taxpayer is to report the total number of animals sold in each of the three preceding years.

**Example 1-9**

Mitch is a dairy farmer who over the past three years has sold raised heifers as follows:

<u>Year</u>	<u>Head</u>
1995	25
1996	30
1997	<u>21</u>
Total	<u>76</u>
Average	<u>25</u>

In 1998, due to a severe drought, Mitch was forced to sell, at \$500 per head, 45 raised heifers due to a lack of availability of feed.

Mitch sold 20 more animals than his previous three-year average. The portion of the gain available for deferral is \$10,000 (20 excess head × \$500).

The election to postpone the gain must include the taxpayer's name, address and the following:

- A statement that the election is made under Section 451(e);
- Evidence of the drought or other conditions which forced the early sale or exchange of the livestock and the date, if known, on which an area was designated as eligible for assistance by the federal government because of drought conditions;
- A statement explaining the relationship of the area of drought or other condition to the early sale or exchange of the livestock;
- The total number of animals sold in each of the three preceding years;
- The number of animals which would have been sold in the tax year had normal business practice been followed in the absence of drought or other conditions;
- The total number of animals sold and the number sold because of drought or other conditions during the tax year; and
- A computation of the income to be postponed for each class of livestock [IRS Pub. 225, Ch. 4].

The election must be made by the due date (including any extension) of the return for the year of sale [Reg. Sec. 1.451-7(g)]. The election can be made on an amended return, but only if filed by the due date. Once made, an election can only be changed with IRS consent.

The election is to be made for each class of animals sold early (e.g., cows, sheep, etc.). A separate election is not required for animals within a general class because of gender, breed or age [Reg. Sec. 1.451-7(d)].

### **Other Issues Regarding Eligibility for Livestock Deferral Election**

The definition of livestock eligible for deferral includes poultry.

**Principal Business of Farming Requirement.** Farming is defined by reference to Section 6420(c)(3), and includes the raising or harvesting of any agricultural or horticultural commodity, including the raising, shearing, feeding, caring for, training, and management of livestock, bees, poultry and fur-bearing animals and wildlife by an owner, tenant or farm operator. See Private Letter Ruling 8928050 for a favorable ruling involving the principal business test (re: a salaried employee who also maintained a cattle ranching business).

**Federally Designated Assistance Area.** The livestock need not be raised within the actual area of drought or other condition, and the sale does not need to occur within the designated area. However, the early sale must have occurred solely on account of the drought or other condition and its impact on water, grazing or other requirements of the animals [Reg. Sec. 1.451-7(c); IRS Notice 89-55, 1989-1 CB 696].

## **REPORTING OF BREEDING STOCK**

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### **Schedule F Reporting**

Livestock held primarily for sale are reported on Schedule F as ordinary income or loss. Livestock raised or purchased with the intent to resell the animals (rather than use for draft, breeding or dairy stock) must be reported on Schedule F. Consequently, these sales proceeds increase earned income and are subject to the self-employed social security tax.

### **Form 4797 Reporting**

Sale proceeds from livestock held primarily for draft, breeding, dairy or sporting purposes (productive Section 1231 animals) are reported on Form 4797.

Livestock held less than 1 year (2 years for horses or cattle), whether sold at gain or loss, are reported on Form 4797, Part II as ordinary gains or losses.

Raised livestock held more than 1 year (2 years for horses and cattle) and sold at a gain are reported on Form 4797, Part I and the gain is treated as capital gain. Capital gain tax rates will apply, based on the holding period for purposes of the different capital gain rates. Because of their zero tax basis to the cash method farmer, raised productive livestock cannot be sold at a loss.

Purchased productive livestock held more than 1 year (2 years for horses and cattle) and sold at a gain are reported on Form 4797, Part III, because of the need to consider Section 1245 depreciation recapture. Losses are reported in Part I as Section 1231 ordinary losses [IRS Pub. 225, Ch. 10 and 11].

The purpose for which an animal is held ordinarily is determined by the actual use of the animal. An animal is not held for draft, breeding, dairy or sporting purposes merely because it is suitable for that purpose, or because it is held for sale to others for use by them for such purposes [IRS Pub. 225, Ch. 10].

**Example 1-10**

George is a dairy farmer with the following transactions:

An animal held for breeding purposes is discovered to be sterile. Its sale, within a reasonable time, is reported on Form 4797 because the animal was held for breeding purposes.

A group of young animals held for breeding purposes is sold early due to a drought. This sale is also reported on Form 4797.

George retires and sells his entire herd, including young animals which were being held for breeding purposes. The entire sale is reported on Form 4797.

*Practice Tip:* Practitioners should not assume that amounts listed in client farm records for “sale of livestock” are automatically to be reported on Schedule F as ordinary income. The client should be questioned as to the reason for disposition and whether any of the animals were intended for breeding purposes. If the animals sold were intended for breeding or other Section 1231 productive purposes, the sale should be reported on Form 4797. While this may not reduce overall taxable income, it can result in significant self-employment tax savings.

The major factor in determining whether livestock sales should be reported on Form 4797 vs. Schedule F is the *intent* as to the use of the animal, even if not actually used as intended prior to sale.

**PATRONAGE DIVIDENDS/PER-UNIT RETAINS****Patronage Dividends**

A patronage dividend is an allocation of taxable income received by a member from a cooperative, based on the member's purchase of farm supplies and equipment or the sale of commodities through the cooperative.

A cooperative is an organization whose purpose is to market products of its members or other producers and return to its members the proceeds of the sales less the necessary marketing expenses [Sec. 521(b)(1)]. Cooperatives may also be organized for the purpose of purchasing supplies and equipment for members, and turning over such supplies and equipment to them at actual cost plus expenses. Cooperatives are taxed at corporate rates on income not distributed to patrons.

Generally, 20-30% of the annual income allocation is paid as a cash dividend or distribution to the patron. The remaining “noncash” portion is retained by the cooperative and held in a patronage equity account designated for the member. The equity account is paid out to the taxpayer at a later date or upon death.

The entire patronage dividend (cash and noncash) is fully taxable in the year the patronage dividend is declared and paid, and is reported on Schedule F, line 5a. Upon later receipt of the equity portion, no reporting is necessary and no taxation results. The entire patronage dividend is reported

directly to the IRS on Form 1099-PATR, so proper reconciliation of income reported and Forms 1099 received must be done annually.

Dividends received on purchases of capital assets or depreciable property are not reported as income; rather, the basis of the asset should be reduced by the dividend [IRS Pub. 225, Ch. 4]. These amounts must be included in the gross dividends received on line 5a of Schedule F so that the Forms 1099 reconcile, but only the taxable part is included on line 5b.

Patronage dividends received that are partly business and partly personal are taxable to the extent related to business. For example, a farmer who deducts 80% of his fuel on Schedule F would only report 80% of the patronage dividend from his fuel co-op in farm income. Again, the gross dividends must be shown on line 5a to reconcile to the Forms 1099, with the taxable portion entered on line 5b.

Dividends received that are directly attributable to purchases of personal items are not included in income. This typically occurs with purchases of home heating oil and fuel for personal vehicles.

### **Per-Unit Retains**

Per-unit retains are written notices of income allocation received from a cooperative based on farm commodities marketed to the cooperative without regard to the net earnings of the cooperative.

Per-unit retains receive the same tax treatment as patronage dividends and should be reported on Schedule F, line 5a, and are also included as fully taxable income on line 5b.

### **Miscellaneous Issues**

**Co-op Equity Losses.** When a co-op permanently reduces a patron's equity account, the co-op issues a statement to the patron indicating the equity write-off. This write-off is fully deductible on Schedule F in the year the writedown occurs [IRS Pub. 225, Ch. 4].

**Nonqualified Notices of Allocation.** Although infrequently done, a cooperative may issue a nonqualified notice of allocation or a nonqualified per-unit retain certificate. These are nontaxable when allocated, and have a zero basis in the hands of the farmer-member. Any amount later received is included as ordinary income on Schedule F. Nonqualified notices of allocation are not reported to the patron as income on Form 1099-PATR.

*Practice Tip:* The tax preparer should assure that the gross amounts of all 1099-PATR income allocations have been reported on line 5a of Schedule F, to avoid IRS computer matching problems. Also, the taxpayer's specific activity with each cooperative should be reviewed, to identify the correct portion of taxable income for line 5b.

**Example 1-11**

Lance, a grain farmer, received the following 1998 Forms 1099-PATR based on his 1997 farming activity:

Farmers Co-op	\$1,000
Gray County Oil Assn.	200
Tri-County Co-op	<u>600</u>
Total	<u>\$1,800</u>

In 1997, Lance and his brother, Lyle, purchased chemicals from Tri-County Co-op for both of their farming operations. The entire dividend was reported under Lance's social security number, although one-half is related to Lyle's purchases.

In 1997, Lance deducted 75% of his gas and oil purchases from Gray County Oil Assn., as a farm deduction.

His activity with Farmers Co-op was entirely grain sales.

On the 1998 Schedule F, Lance should report his dividend income as follows:

- Line 5a, Total Cooperative Distributions \$1,800
- Line 5b, Taxable Amount \$1,450  
 $[\$1,000 + (\$200 \times 75\%) + (\$600 \times 50\%)]$

**OTHER INCOME ISSUES****Easements**

Income received for granting an easement or right-of-way first reduces the basis in the land. Any excess is reported as Section 1231 income on Form 4797 [IRS Pub. 225, Ch. 4; Rev. Rul. 68-21, 1968-1 CB 351].

**Example 1-12**

Mike Angelo received \$1,200 for an easement he gave to a utility for laying a pipeline beneath a corner of his farm. Mike's basis in the land is \$1,000 per acre. The easement encompassed one-half acre, and Mike reserved the right to continue farming the surface land after the pipe was installed.

Mike should reduce his basis in the land by \$500 ( $\$1,000/\text{acre} \times .5$ ) and report a Section 1231 gain of \$700.

The granting of a perpetual easement where no beneficial interest is retained is treated as an outright sale. Easements for a limited term are generally treated as rental income [Rev. Rul. 72-255, 1972-1 CB 221; *W.J. Wineberg*, 326 F2d 157, 64-1 USTC 9156]. If growing crops are damaged, proceeds recovered are reported on Schedule F as income [IRS Pub. 225, Ch. 4].

### **Conservation Reserve Program (CRP) Payments**

Under the CRP, an owner of farmland enters into a long-term agreement with the U.S. Department of Agriculture. The agreement stipulates that in return for an "annualized rental payment," the land owner agrees to convert the land to a less intensive use. The payment may be made in cash, commodity certificates or a combination of both.

All CRP payments are reported to the taxpayer at year-end by the U.S. Department of Agriculture on Form 1099-G (coded as Program No. 22).

The payment is reported on Schedule F, line 6 as taxable agricultural program payments if the CRP payment is a receipt from farm operations in which the farmer materially participates. If the taxpayer is a landlord who rents his or her land to others and does not meet the material participation tests, the CRP payment is reported on Form 4835 [Letter of 3/10/87 from Peter K. Scott, Associate Chief Counsel-Technical, IRS; IRS Pub. 225, Ch. 4; PLR 8822064].

### **Dwelling Furnished to a Tenant**

The value of a dwelling furnished to a tenant farmer by the landowner under a usual tenant-farmer arrangement is nontaxable income to the tenant [Sec. 119; IRS Pub. 225, Ch. 4; Rev. Rul. 70-72, 1970-1 CB 15].

### **Federal Gas Tax Credit**

Taxpayers can claim a refundable credit for federal tax paid on fuel used for farm off-highway business use. This credit does not apply to fuel used in a highway vehicle registered for use on public highways, even if the vehicle is used off-highway [Sec. 34].

Records must be maintained which will allow the IRS to verify the amount claimed. The records should include:

- The total number of gallons purchased *and used* during the period covered by the claim;
- The dates of the purchases;
- The names and addresses of suppliers and amounts purchased from each during the period covered by the claim;
- The purpose for which the fuel was used; and
- The number of gallons used for each purpose [IRS Pub. 225, Ch. 18].



The current rate of tax per gallon is:

- Gasoline: 18.4 cents (through 9/30/99).
- Gasohol (10%): 13.0 cents (through 9/30/99).
- Diesel fuel and (effective July 1, 1998) kerosene: 24.4 cents (through 9/30/99).
- Special motor fuels: 18.4 cents (through 9/30/99).
- Aviation fuels (other than gasoline): 21.9 cents (through 3/31/2005) [Secs. 4081 and 4091].

The credit is claimed on Form 4136, "Credit for Federal Tax on Fuels." Form 4136 is filed with the taxpayer's annual tax return. To receive a refund prior to the filing of the annual tax return, a Form 843, "Claim for Refund," may be filed. This refund claim can only be filed to claim a refund for excise tax on gasoline and special motor fuel used in a farming operation. This claim can be filed on a quarterly basis for any of the first three quarters of the tax year.

The credit or refund received must be reported as income on Schedule F, line 10—other income, if a deduction was taken on the tax return for the taxes paid and that deduction reduced the tax liability. The time for reporting depends on the method of accounting. Cash basis farmers report the income in the year following the year the credit is claimed.

*Practice Tip:* The federal road tax of 18.4 cents per gallon is charged on all farm bulk purchases of *gasoline*. Accordingly, all farmers who use some portion of their gasoline in nonroad farm use should be entitled to claim a credit on Form 4136.

Conversely, suppliers can sell *diesel* fuel meeting dyeing requirements without the federal road tax, if the farmer has notified the supplier of the exempt farm use of the fuel. Farmers who use diesel fuel for both taxable and nontaxable purposes should buy dyed diesel fuel tax free in the amount reasonably projected to be used for nonroad farm purposes.

### Cash Rent and Crop Shares

Cash and crop share rental arrangements must be reviewed to determine whether or not the landlord materially participates. Landlords who materially participate are subject to self-employment tax, and report on Schedule F in the same manner as active farm proprietors.

**Material Participation.** A landlord is considered to materially participate if the landlord has an arrangement with the tenant involving the landlord's participation [Pub. 225, Ch. 15]. In addition, the landlord must meet one of the four following tests:

- The landlord does any three of the following:
  - Pays or stands good for at least half the direct costs of producing the crop;
  - Furnishes at least half the tools, equipment, and livestock used in producing the crop;
  - Consults with the tenant; and
  - Inspects the production activities periodically [Reg. Sec. 1.1402(a)-4(b)(3)(iii)].

- The landlord regularly and frequently makes or takes an important part in making management decisions substantially contributing to or affecting the success of the enterprise;
- The landlord works 100 hours or more, spread over a period of five weeks or more, in activities connected with crop production; or
- The landlord does things which, considered in their total effect, shows that he is materially and significantly involved in the production of the farm commodities.

**Cash Rent.** If an individual receives rent for farmland and *does not* materially participate, the income is rental income and is reported on Schedule E. The income *is not* subject to self-employment tax. If an individual receives rent for farmland and *does* materially participate, the income is farm income and is reported on Schedule F. The income *is* subject to self-employment tax. This reporting may require special reconciliation of Forms 1099 since the IRS will match rent income directly to Schedule E.

**Crop Shares.** Crop shares received by an individual who materially participates in the operation of the farm *are* subject to self-employment tax and are reported on Schedule F [Reg. Sec. 1.1402(a)-4(b)].

Crop shares received by an individual who does not materially participate in the operation of the farm *are not* subject to self-employment tax and are reported on Form 4835.

### **Rental of Personal Property: Business vs. Rental Status**

In defining self-employment income, Section 1402(a)(1) contains an exception for “rentals from real estate and from personal property leased with real estate.” The sole leasing of personal property is subject to SE tax (*Carl Stevenson*, 1989 TC Memo 357).

A notation at the top of Schedule E directs taxpayers to report income and expenses from the business of renting personal property on Schedule C or C-EZ.

*(Text continued on page 25)*

**1997 SCHEDULE E**

**SCHEDULE E  
(Form 1040)**

**Supplemental Income and Loss**  
(From rental real estate, royalties, partnerships,  
S corporations, estates, trusts, REMICs, etc.)

OMB No. 1545-0074

**1997**

Attachment  
Sequence No. 13

Department of the Treasury  
Internal Revenue Service (99)

▶ Attach to Form 1040 or Form 1041. ▶ See instructions for Schedule E (Form 1040).

Name(s) shown on return

Your social security number

**Part I** **Income or Loss From Rental Real Estate and Royalties** *Note: Report income and expenses from your business of renting personal property on Schedule C or C-EZ (see page E-1). Report farm rental income or loss from Form 4835 on page 2, line 39.*

1	Show the kind and location of each rental real estate property:	2	For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of:	Yes	No
A	.....	• 14 days, or • 10% of the total days rented at fair rental value? (See page E-1.)	A		
B	.....		B		
C	.....		C		

	Properties			Totals (Add columns A, B, and C.)
	A	B	C	
<b>3</b> Rents received . . . . .	<b>3</b>			<b>3</b>
<b>4</b> Royalties received . . . . .	<b>4</b>			<b>4</b>
<b>Expenses:</b>				
<b>5</b> Advertising . . . . .	<b>5</b>			
<b>6</b> Auto and travel (see page E-2) . . . . .	<b>6</b>			
<b>7</b> Cleaning and maintenance . . . . .	<b>7</b>			
<b>8</b> Commissions . . . . .	<b>8</b>			
<b>9</b> Insurance . . . . .	<b>9</b>			
<b>10</b> Legal and other professional fees . . . . .	<b>10</b>			
<b>11</b> Management fees . . . . .	<b>11</b>			
<b>12</b> Mortgage interest paid to banks, etc. (see page E-2) . . . . .	<b>12</b>			<b>12</b>
<b>13</b> Other interest . . . . .	<b>13</b>			
<b>14</b> Repairs . . . . .	<b>14</b>			
<b>15</b> Supplies . . . . .	<b>15</b>			
<b>16</b> Taxes . . . . .	<b>16</b>			
<b>17</b> Utilities . . . . .	<b>17</b>			
<b>18</b> Other (list) ▶ ..... ..... .....	<b>18</b>			
<b>19</b> Add lines 5 through 18 . . . . .	<b>19</b>			<b>19</b>
<b>20</b> Depreciation expense or depletion (see page E-2) . . . . .	<b>20</b>			<b>20</b>
<b>21</b> Total expenses. Add lines 19 and 20 . . . . .	<b>21</b>			
<b>22</b> Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-3 to find out if you must file Form 6198. . . . .	<b>22</b>			
<b>23</b> Deductible rental real estate loss. <i>Caution: Your rental real estate loss on line 22 may be limited. See page E-3 to find out if you must file Form 8582. Real estate professionals must complete line 42 on page 2 . . . . .</i>	<b>23</b>	( )	( )	( )
<b>24</b> Income. Add positive amounts shown on line 22. Do not include any losses . . . . .	<b>24</b>			
<b>25</b> Losses. Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here . . . . .	<b>25</b>			( )
<b>26</b> Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 39 on page 2 do not apply to you, also enter this amount on Form 1040, line 17. Otherwise, include this amount in the total on line 40 on page 2 . . . . .	<b>26</b>			

# 1997 SCHEDULE E

Schedule E (Form 1040) 1997

Attachment Sequence No. 13

Page 2

Name(s) shown on return. Do not enter name and social security number if shown on other side.

Your social security number

Note: If you report amounts from farming or fishing on Schedule E, you must enter your gross income from those activities on line 41 below. Real estate professionals must complete line 42 below.

### Part II Income or Loss From Partnerships and S Corporations

Notes: If you report a loss from an at-risk activity, you MUST check either column (e) or (f) on line 27 to describe your investment in the activity. See page E-4. If you check column (f), you must attach Form 8198.

27	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	Investment At Risk? (e) All is at risk (f) Some is not at risk	
A						
B						
C						
D						
E						

Passive Income and Loss			Nonpassive Income and Loss		
(g) Passive loss allowed (attach Form 8582 if required)	(h) Passive income from Schedule K-1	(i) Nonpassive loss from Schedule K-1	(j) Section 179 expense deduction from Form 4562	(k) Nonpassive income from Schedule K-1	
A					
B					
C					
D					
E					
28a Totals					
b Totals					
29	Add columns (h) and (k) of line 28a				29
30	Add columns (g), (i), and (j) of line 28b				30 ( )
31	Total partnership and S corporation income or (loss). Combine lines 29 and 30. Enter the result here and include in the total on line 40 below				31

### Part III Income or Loss From Estates and Trusts

32	(a) Name	(b) Employer identification number
A		
B		

Passive Income and Loss		Nonpassive Income and Loss	
(c) Passive deduction or loss allowed (attach Form 8582 if required)	(d) Passive income from Schedule K-1	(e) Deduction or loss from Schedule K-1	(f) Other income from Schedule K-1
A			
B			
33a Totals			
b Totals			
34	Add columns (d) and (f) of line 33a		34
35	Add columns (c) and (e) of line 33b		35 ( )
36	Total estate and trust income or (loss). Combine lines 34 and 35. Enter the result here and include in the total on line 40 below		36

### Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs)—Residual Holder

37	(a) Name	(b) Employer identification number	(c) Excess inclusion from Schedules Q, line 2c (see page E-5)	(d) Taxable income (net loss) from Schedules Q, line 1b	(e) Income from Schedules Q, line 3b
38	Combine columns (d) and (e) only. Enter the result here and include in the total on line 40 below				38

### Part V Summary

39	Net farm rental income or (loss) from Form 4835. Also, complete line 41 below				39
40	TOTAL income or (loss). Combine lines 26, 31, 36, 38, and 39. Enter the result here and on Form 1040, line 17 ▶				40
41	Reconciliation of Farming and Fishing Income. Enter your gross farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), line 15b; Schedule K-1 (Form 1120S), line 23; and Schedule K-1 (Form 1041), line 14 (see page E-5)				41
42	Reconciliation for Real Estate Professionals. If you were a real estate professional (see page E-4), enter the net income or (loss) you reported anywhere on Form 1040 from all rental real estate activities in which you materially participated under the passive activity loss rules.				42

*Observation:* Combining equipment and real estate leases into a single lease is one solution for those leasing equipment and real estate. When only equipment is leased, the use of an S corporation to act as the lessor may be a viable solution. Although some officer compensation must be withdrawn from the corporation for attending to administrative duties, most of the S-corporate earnings should be able to be extracted as non-FICA shareholder distributions, due to the passive nature of the activity.

### **Income Averaging for 1998, 1999 and 2000**

The Taxpayer Relief Act of 1997 added a special “income averaging” tax computation privilege for farmers, effective for taxable years beginning after December 31, 1997:

- Individuals engaged in farming are allowed to elect to average farm income over three years; the provision does not apply to estates or trusts or corporations.
  - A farming business includes the trade or business of farming, along with the operation of a nursery or sod farm, the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees.
  - “Elected farm income,” which may be averaged over the prior three years, means the amount of taxable income attributable to any farming business which is specifically elected by the taxpayer as subject to the three year averaging method. Farming taxable income includes gain from the sale or disposition of property (other than land) regularly used by a farmer for a substantial period in a farming business.
  - The tax imposed for the year in which income averaging is elected is the sum of the tax for that year on income reduced by the amount of “elected farm income,” plus the increase in tax which would have occurred if taxable income for each of the three previous tax years was increased by an amount equal to one-third of the elected farm income.
- Income averaging is available to farmers for three years: 1998, 1999 and 2000 (IRC Sec. 1301).
- Any adjustment to taxable income for a previous year because of the “elected farm income” amount carried back to that year is taken into account in applying the income averaging provision for any subsequent taxable year (i.e., the income of the past years must be adjusted upward for a future year’s computation after income averaging has been used).
- Income averaging has no application to calculation of the self-employment tax or the Alternative Minimum Tax, nor does a provision require the recalculation of the tax liability of any other taxpayer, such as a minor child subject to kiddie tax rules.
- **Observations:**
  - The fact that income averaging has no impact on self-employment tax creates interesting planning opportunities. In the base years prior to income averaging, a farmer could report income beneath the first tier social security base (currently \$68,400 for 1998), and subsequently report substantial farm self-employment income exceeding the SE base. Income averaging would smooth out the income tax costs of the high tax year, and significant self-

employment tax would be saved by having much of the income exceeding the SE base.

- On the other hand, the fact that regular income tax *after* income averaging must be compared to current AMT without averaging imposes a significant risk. If income averaging is used to significantly reduce the regular income tax, it is likely that AMT will come into play.
- Income averaging will need to be considered in virtually every individual farm return for the years 1998 through 2000. To the extent that the prior three years contain any lower bracket years, averaging a sufficient amount of income to fill the lower bracket availability will be appropriate. Recognize the significant flexibility which occurs because *any portion* of current year net farm income can be elected for averaging.

### Example 1-13

Jim and Jane are married with two dependent children, and use the standard deduction. Jim's Schedule F income for the year is \$120,000 (assume the 1998 year). In the past, Jim and Jane have been reporting taxable income in the 15% bracket. Each year of the prior three years would need approximately \$20,000 of additional taxable income to reach the top of the 15% tax bracket.

Jim and Jane could elect to apply income averaging to \$60,000 of current farm income or gains. This would reduce their current tax liability by \$7,800 (\$20,000 of income  $\times$  3 years  $\times$  13% rate differential). This reduces their 1998 federal tax liability to approximately \$14,000 (about \$21,800 of regular tax less \$7,800 of tax savings). However, because current year AMT is calculated at \$18,000, Jim and Jane would be subject to the AMT in the current year. They would still achieve income tax savings of over \$3,000 (\$7,800 of regular tax savings offset by about \$4,000 of AMT). Additionally, there could be self-employment tax advantages because current year Schedule F income is significantly above the social security first tier base amount (presuming that some of this Schedule F income would have been reported within the base amount if taxed in other years).

• Illustrations of self-employment tax savings with income averaging:

- Level income vs. lower base with larger year subject to income averaging.

	1995	1996	1997	1998
Sch. F level (no income averaging)	\$ 60,000	\$ 60,000	\$ 60,000	\$ 60,000
Sch. F net planned for income averaging	\$ 40,000	\$ 40,000	\$ 40,000	\$120,000
Tax result:				
Income averaging savings		\$ 0		
SE tax savings		5,500		
Less AMT cost		(3,500)		
Net tax savings		<u>\$ 2,000</u>		

— Income averaging plan for two years (1998 and 1999).

	1995	1996	1997	1998	1999
Sch. F level (no income averaging)	\$ 72,000	\$ 72,000	\$ 72,000	\$ 72,000	\$ 72,000
Sch. F net planned for income averaging	\$ 40,000	\$ 40,000	\$ 40,000	\$ 120,000	\$ 120,000
Tax result:					
Income averaging savings			\$ 1,800		
SE tax savings			9,500		
Less AMT cost			(4,400)		
Net tax savings			<u>\$ 6,900</u>		

**EXHIBIT 1-1****SAMPLE ELECTION TO DEFER REPORTING OF CROP INSURANCE  
AND DISASTER PROCEEDS**

I.D. No. \_\_\_\_\_

\_\_\_\_\_  
\_\_\_\_\_**STATEMENT RE: DEFERRAL OF CROP INSURANCE  
ATTACHMENT TO SCHEDULE F, LINE 8**

- I. The taxpayer elects to defer reporting of crop insurance and disaster proceeds under Section 451(d) of the Internal Revenue Code of 1986 and Section 1.451-6 of the Regulations.
- II. The crop destroyed was \_\_\_\_\_
- III. Under normal business practice, income from the destroyed and damaged crops would have been included in gross income in a later tax year.
- IV. The cause of the damage was \_\_\_\_\_  
Date of damage \_\_\_\_\_
- V. The total amount of payment received \_\_\_\_\_
- VI. Name of insurance carrier \_\_\_\_\_



**EXHIBIT 1-2****SAMPLE ELECTION TO ADOPT CCC INCOME METHOD****SAMPLE ELECTION TO ADOPT CCC  
INCOME METHOD**

Pursuant to IRC Section 77, taxpayer hereby elects to report all loans from Commodity Credit Corporation as income in the year received. The following loans were received during this taxable year:

Amount of loan	_____
Commodity	_____
Quantity in bushels	_____

**EXHIBIT 1-3**

**SAMPLE ELECTION TO DEFER LIVESTOCK SALE**

I.D. No. \_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

**ELECTION TO DEFER LIVESTOCK SALES**

- I. The taxpayer hereby elects to defer reporting of livestock sale proceeds under IRC Section 451(e).
- II. Taxpayer's area of   (City)  ,   (State)   has been classified as a   (Year)   drought, flood, or other weather condition relief area eligible for federal government assistance.
- III. The   (Year)   drought, flood, or other weather condition has reduced feed supplies, necessitating the early sale of a portion of the taxpayer's livestock.
- IV. Number of animals sold in the three preceding years:

<u>Year</u>	<u>Animals Sold</u>
19X1	XX
19X2	XX
19X3	<u>XX</u>
	<u>XX</u>
Average for 3 years	<u>XX</u>

- V. Number of animals that would have been sold in the tax year under normal business practice in the absence of a drought, flood, or other weather condition: XX
- VI. Total number of animals actually sold in   (Year)   was XX. The number sold early because of the drought was therefore XX.
- VII. Income to be postponed:
  - (Year) sale price of breeding/cull stock     \$XXXX
  - Divided by number of animals sold             XX
  - Equals ave. sale price \$XX/head
  - Excess heads sold × \$XX is
  - Income to be Deferred to   (Year)               \$XXXX

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## **CHAPTER 2**

### **FARM EXPENSE ISSUES**

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#### **OVERVIEW**

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An understanding of this chapter will enable you to:

- Identify personal use items which must be prorated on Schedule F.
- Apply the various rules and limitations relating to business vehicles.
- Determine the deductibility of prepaid expenses.
- Decide whether to utilize current year deduction vs. deferral of fertilizer expense.
- Identify Section 179 depreciation limits and understand issues arising with depreciation of farm assets.
- Determine the allowable deduction of soil and water conservation expenditures.

#### **INTRODUCTION**

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Ordinary and necessary costs of operating a farm business are deductible. Farming enterprises often have the business operation and owner residence at the same location, leading to allocation issues to determine the proper partial deduction. Several special tax rules govern certain expenditures, such as fertilizer and conservation costs and prepaid feed, which are unique to farm taxpayers. This chapter will identify many of farm taxpayers' common expenses and discuss deductibility of these expenses.

To provide an overview of farm expense issues, a copy of the 1997 Farm Worksheet the authors distribute to their farm clients has been included as Exhibit 2-1.

#### **PERSONAL USE ITEMS**

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The IRS allows a deduction for business expenses only to the extent of business use. Some expenses are partly business and partly personal. These mixed expenses must be allocated since the personal portion is nondeductible. No specific rules exist for the computation. However, all allocations must be reasonable [Sec. 262; IRS Pub. 225, Ch. 5].

## Expense Categories Requiring Allocations

**Personal Consumption of Raised Products.** Expenses attributed to producing food for consumption by the taxpayer and his family (e.g., livestock, vegetables) should be removed from farm operating expenses.

*Practice Tip:* The Schedule F instructions simply state that expenses should not be deducted for items used by the taxpayer or family. Rather than attempt to adjust many accounts for nominal amounts of expense (feed, utilities, supplies, etc.), many practitioners will record a single amount in Schedule F "other income" to represent the estimated *cost* of personally consumed items (generally designated as "personal consumption").

**Interest Expense.** The interest expense allocated to the personal residence or other personal items must be removed from farm operating expenses. Generally, to the extent secured by residential realty, home acquisition or home equity interest expense will be deductible on Schedule A.

**Real Estate Taxes.** The portion of the real estate taxes for the personal residence should be reported on Schedule A. This generally requires a subjective allocation, as many real estate tax statements do not differentiate between the residence and farm buildings located at the same site.

**Insurance.** The insurance premiums on the personal residence property coverage are not deductible [Reg. Sec. 1.262-1(b)(2)]. Premiums for life and disability income policies are not deductible [Sec. 264].

**Utilities.** The basic local telephone service (including taxes thereon) with respect to the first telephone line to the residence is not deductible [Sec. 262(b)]. However, any charge for a second farm line is deductible [IRS Pub. 225, Ch. 5]. The portion of electricity and other household utilities which is used personally is not deductible [Reg. Sec. 1.262-1(b)(3)].

**Professional Fees.** Legal fees associated with the purchase of capital assets must be capitalized. Legal fees associated with personal matters (will, etc.) are not deductible.

The portion of tax preparer fees reasonably allocable to Schedule F and Schedule C proprietorships, and to Schedule E rental and royalty activities, may be claimed as part of the deductions associated with those activities. The remaining portion of the tax return preparation fee must be claimed as a miscellaneous itemized deduction, subject to the 2%-of-AGI floor [Rev. Rul. 92-29, IRB No. 1992-16].

Fees incurred in contesting tax deficiencies related to Schedule C or F proprietorship matters, or to Schedule E rental and royalty properties, may also be deducted in arriving at AGI.

*Practice Tip:* Revenue Ruling 92-29 effectively reversed a much publicized private ruling [PLR 9126014], which held that virtually all tax return and consulting fees associated with a Form 1040 were to be treated as miscellaneous itemized deductions.

In issuing tax return preparation fee statements, CPA firms should provide an allocation of their fees between farm tax and accounting matters vs. the basic Form 1040 portion of the return.

## BUSINESS USE OF VEHICLES

The IRS allows a deduction for the business portion of the operating expenses of vehicles. The personal portion of vehicle expenses is not deductible.

### Calculating the Deduction

There are two methods available to calculate the deductible vehicle expenses:

**Actual Cost Method.** The business portion of actual operating expenses such as fuel, oil, tires, repairs, insurance, depreciation, parking fees, tolls, and licenses are deductible.

#### Example 2-1

Otto Baynes is a farmer and uses a pickup in his business. He purchased a new pickup for \$18,000 in January 1998 and spent \$2,000 for gasoline, oil, insurance, and maintenance, and paid \$1,200 interest to GMAC.

His log reflects 25,000 total miles and 20,000 driven for business purposes, or 80% business use.

Using the actual cost method, Otto reports the following vehicle expenses in 1998:

Depreciation on Schedule F, (\$ 3,160 maximum allowance × 80%)	\$ 2,528
Vehicle expenses on Schedule F, (\$2,000 × 80% business use)	1,600
Interest on Schedule F, line 23b (\$1,200 × 80% business use)	<u>960</u>
Total farm vehicle deductions	<u>\$ 5,088</u>

**Standard Mileage Rate Method.** This simplified method of computing vehicle expenses eliminates the detailed recordkeeping of most expenditures. Instead of using actual expenses, the taxpayer only keeps a log of business miles. A standard rate of 32.5¢ per business mile is allowed for 1998 [Rev. Proc. 97-58]. In addition, the business portion of parking fees, tolls and interest expense may be deducted.

This method is not available for two or more vehicles used simultaneously, such as in fleet operation, or for vehicles which are leased rather than owned [IRS Pub. 917, Ch. 1; Rev. Proc. 97-58, 1997-52 IRB 24]. It is also available only for cars and light trucks such as vans, pickups and panel trucks, and is not to be used for heavy trucks [IRS Pub. 225, Ch. 5].

**Example 2-2**

Using the same fact pattern as in Example 2-1, Otto would report the following expense in 1998 if he used the standard mileage rate method instead of the actual cost method:

Business miles on Schedule F (20,000 × 32.5¢)	\$ 6,500
Interest on Schedule F (\$1,200 × 80% business use)	<u>960</u>
Total farm vehicle deductions	<u>\$ 7,460</u>

**Switching Methods**

**Vehicle Expenses Incurred Before 1990.** If the standard mileage rate method was desired, it had to be elected in the first year the vehicle was placed in service. The taxpayer can switch from the standard mileage rate method to the actual method in a later year. However, the depreciation calculation is to be based on the straight-line method for the estimated useful life of the automobile [Rev. Proc. 82-61, 1982-2 CB 849, as updated by Rev. Proc. 89-66, 1989-2 CB 792].

**Expenses Paid or Incurred After 1989.** Beginning in 1990, the annual Revenue Procedures adjusting the IRS mileage rate have allowed the taxpayer to use the standard mileage rate on a yearly basis. It is no longer a requirement that the standard mileage rate be elected in the first year that the vehicle is placed in service [Rev. Proc. 89-66, 1989-2 CB 792, Rev. Proc. 90-59, 1990-2 CB 644; Rev. Proc. 97-58, 1997-52 IRB 24].

A vehicle may be switched from the actual method to standard mileage rate, but only if the vehicle was depreciated using the straight line method over the estimated useful life while on the actual method. If ACRS or MACRS depreciation was used under Section 168, or if Section 179 first year depreciation was claimed, a switch to the standard mileage rate may not be claimed.

As in the past, the taxpayer may switch from the standard mileage rate to the actual cost method. However, straight-line depreciation must be used for the vehicle's estimated useful life, subject to the Section 280F passenger vehicle depreciation limits.

*Practice Tip:* The Section 280F "luxury auto" annual depreciation limits generally restrict the depreciation deduction to the maximum amount (i.e. \$3,160 first year, \$4,900 second year, etc.), regardless of which depreciation method is used, and the same limitations apply to Section 179 first year depreciation.

Accordingly, to maintain eligibility for a switch to the standard mileage rate in future years, tax practitioners should consider an election out of MACRS under Section 168(f). This statute permits avoidance of ACRS/MACRS if the asset is depreciated using a method other than time (i.e. depreciation of a vehicle over its estimated useful total mileage life).

### Additional Deduction for Qualified Clean-Fuel Vehicles

The 1997 Taxpayer Relief Act added a provision that may result in additional depreciation deductions—unlimited by the Sec. 280F “luxury auto” maximum amounts—for amounts spent to install “qualified clean-burning fuel” components on a vehicle. This means that if a taxpayer purchases a vehicle for farm use, and pays to have such components (e.g., retrofit parts) installed on the vehicle so that it can burn clean-burning fuel, then the cost of the components may be depreciated without regard to the Sec. 280F limits. This deduction is in addition to the usual first-year depreciation deduction allowed for the vehicle [Sec. 280F(a)(1) ( C ); 179A].

In addition, the luxury auto limits are triple under the 1997 Act in the case of a purchase of an electric-powered vehicle. The new-law provision applies to vehicles placed in service between August 5, 1997 and January 1, 2005.

### Adjusted Basis of Vehicles on Standard Mileage Rate

For any year in which the business standard mileage rate has been used, depreciation is considered to have been allowed at the following rates:

<u>Years</u>	<u>Depr. Rate per Mile</u>
1980 and 1981	\$.07
1982	.075
1983 thru 1985	.08
1986	.09
1987	.10
1988	.105
1989 thru 1991	.11
1992 and 1993	.115
1994 through 1998	.12

The deemed depreciation calculated under this table reduces the basis of the vehicle for gain, loss, or trade purposes, but not below zero [Rev. Proc. 97-58].

*Practice Tip:* The basis reduction which occurs from deemed depreciation under the business standard mileage rate is often significantly less than the economic deflation in the value of the vehicle (e.g. a vehicle driven 10,000 business miles in 1998 has a basis reduction of \$1,200 for the business portion of the vehicle).

Tax practitioners should advise clients that the adjusted tax basis of vehicles using the standard mileage rate may be greater than value, such that a sale at disposition would produce a deductible Section 1231 tax loss; a trade in this situation therefore defers the tax basis into the next vehicle.

This advice would also be appropriate where vehicles using the actual method have been restricted by the Section 280F limits, and also have a tax basis greater than value at time of disposition.

### Recordkeeping and Substantiation

A taxpayer must have adequate records or sufficient evidence to support the business use of a vehicle [Sec. 274(d)(4)].

The taxpayer must be able to prove:

- The amount of each separate expense for a vehicle, such as the cost of buying the vehicle, the cost of capital improvements, lease payments, the cost of maintenance and repairs, and other expenses
- The mileage for each business use of the vehicle and the total miles for the tax year;
- The date of the expense or use; and
- The business reason for the expense or use of the vehicle [IRS Pub. 917].

IRS Publication 917 suggests using an account book, diary, log, statement of expense, trip sheet or similar records supported by adequate documentary evidence.

Records do not need to be kept contemporaneously. However, documentary evidence compiled at or near the time of the expense has more value than a statement prepared later when there is generally a lack of accurate recall [Reg. 1.274-5T(c)(2)].

**Qualified Nonpersonal Use Vehicles.** The substantiation requirements of Section 274(d) do not apply to vehicles which, by reason of nature or design, are not likely to be used for more than a de minimis amount of personal use [Reg. Sec. 1.274-5T(k)]. Examples of such qualified nonpersonal use vehicles given in the regulations include combines, tractors and other special purpose farm vehicles, and any vehicle designed to carry cargo with a gross vehicle weight over 14,000 pounds.

**Sampling.** Sampling involves maintaining adequate records for a portion of the tax year and using that substantiation for the entire tax year [Reg. Sec. 1.274-5T(c)(3)(ii)]. Sampling is only available as an approved method if the taxpayer can demonstrate by other evidence that the sampling period is representative of the use throughout the tax year.

#### Example 2-3

Myron Adams uses his pickup in his hog farming operation. For the first 3 months of the year, a representative period of his pickup use, Myron kept a log of his farming use of the pickup which determined that 80% was business use.

Myron may use this sample as applying to the entire tax year, so that he will not be required to keep a log for the other 9 months of the year.



**Section 179 Exception to Luxury Vehicle Depreciation Limits.** Vehicles with a “gross vehicle weight” (GVW) in excess of 6,000 pounds are not subject to the “luxury auto” depreciation limits. Accordingly, such vehicles are eligible for a larger Section 179 writeoff, assuming business use exceeds 50% [IRC Sec. 280F(d)(5)(A)(ii) and Reg. Sec. 1.280F-6T(c)(1)(ii)]. The GVW rating is determined by the manufacturer and can be found in the specifications area of the vehicle’s technical data.

The vehicle is still subject to the substantiation requirements of Section 274(d) if its GVW is 14,000 pounds or less [Reg. Sec. 1.274-5T(k)(2)(ii)(C)].

#### **Example 2-4**

Joe Farmer purchases a full-size 3/4 ton pickup for his farming operation. He uses it 75% of the time for farming purposes. The total cost of the vehicle is \$19,500.

Assume the pickup has a GVW in excess of 6,000 pounds. Joe can take a Section 179 deduction on this pickup of \$14,625 ( $\$19,500 \times 75\%$ ).

*Observation:* Section 179 is discussed in depth starting on page 42.

#### **Safe-Harbor for Farm Vehicles**

An automatic 75% qualified business use may be claimed in the case of a vehicle used during most of a normal business day directly in connection with the business of farming. No substantiation is required [Reg. Sec. 1.274-6T(b)(1)].

The regulations contain no technical restriction on using the 75% safe harbor for more than one vehicle in the same farming operation.

*Practice Tip:* The 75% safe-harbor rate for a farm-use vehicle is only available if selected in the tax return [Reg. Sec. 1.274-6T(d)]. Accordingly, if a farmer elects to use a percentage greater than 75%, he will not be allowed on audit to drop down to the 75% safe harbor. Rather, the business use of the vehicle can only be determined through documentation.

#### **OFFICE-IN-HOME DEDUCTION**

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Effective for 1992 and later returns, the U.S. Supreme Court substantially restricted the ability to claim business-in-home deductions through its opinion in the landmark *Soliman* case [*N.E. Soliman*, 93-1 USTC ¶50,014, U.S. Sup. Ct., rev’g 91-1 USTC ¶50,291, CA-4, and 94 TC No. 20, 1990].

In the *Soliman* case, a self-employed anesthesiologist was denied a home office deduction for a room in his home that he used exclusively to perform essential administrative and management tasks for his profession. The Supreme Court said the home office was not Dr. Soliman’s ‘principal place of business’ as required by Sec. 280A(c), because the most important activities of his

practice of anesthesiology were performed in hospitals, and not in the office. The home office was not used to meet with patients, and was not a separate structure—two factors that would have qualified it as a home office under other paragraphs of Sec. 280A.

Effective for 1999 and later years, the 1997 Taxpayer Relief Act overturns *Soliman*. The Act provides that the term 'principal place of business' includes a place of business used for administrative or management activities, if the taxpayer has no other fixed place of business, and if the home office is used exclusively and regularly for this purpose [Sec. 280A].

Although few taxpayers engaged in farming were affected by the *Soliman* case, we mention it here so that practitioners can plan effectively for clients who were affected.

Form 8829, "Expenses for Business Use of Your Home," is only required to be filed when Schedule C is used.

## PREPAID EXPENSES—LIMITATIONS

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A cash-basis taxpayer is allowed to deduct expenses paid during the year. This includes prepayment of expenses. However, prepayments are subject to three different sets of rules which may prevent current deductibility.

### General Prepaid Expense Rules of Revenue Ruling 79-229

In a 1979 ruling, the IRS identified three tests which must be met for a prepaid expense to be currently deductible. Although this ruling uses prepaid livestock feed as its focus, it is considered to have application to any prepaid supply item [Rev. Rul. 79-229, 1979-2 CB 210].

**Test 1.** The expenditure made must be an actual purchase; it cannot be a mere deposit to buy in the future.

In distinguishing between a prepayment and a deposit, Revenue Ruling 79-229 suggests four factors that would show a deposit, rather than a purchase. Although not necessarily all-inclusive, the factors are:

- Absence of a specific quantity of items being bought;
- A right to a refund of any credit that remains;
- Treatment of the expenditures as a deposit on the seller's books; and
- A right to substitute other goods or products for those specified in the contract.

*Practice Tip:* A cash-method farmer who prepays expenses at year-end must get an invoice that clearly specifies a definite quantity, quality, and price for the items bought. There should be no right to a refund or repurchase noted on the invoice. However, the courts have generally approved deductibility where delivery occurred after year end, and the contract price was adjusted to reflect market value at the date of delivery [*R.D. Cravens*, 272 F2d 895, CA-10 (1960); *J. Ernst*, 32 TC 181 (1950); see also IRS Pub. 225, Ch. 5].

**Test 2.** The expenditure must be made for a business purpose and not merely to avoid taxes. As a general rule, farmers normally can establish that prepaid acquisition of various items is for legitimate business purposes. Examples of business reasons for early purchase have included securing adequate quantities, discounts for early purchase, and expectations of rising costs [*Van Raden v. Comm.*, 71 TC 1083, aff'd., 650 F2d 1046, CA-9, 1981].

**Test 3.** The expenditure must not result in a material distortion of income. The revenue ruling lists the following factors for determining whether the deduction resulted in a material distortion of income:

- The relationship between quantity purchased and the projected quantity to be used in the next year;
- Materiality of the expenditure in relation to total income of the taxpayer for the year;
- Normal and customary business practices of the taxpayer in buying supplies, and the business purpose for paying in advance;
- The relationship between the expenditure and past purchases;
- The time of year in which the expenditure was made; and
- How deductions of prepaid expenditures have affected taxes paid by the farmer in previous years.

*Practice Tip:* Although case law has not provided clear guidance as to when a distortion of income occurs, as a general rule purchases made for the upcoming crop year would not constitute a distortion of income. Similarly, purchases of items such as feed would not normally constitute a distortion of income if they could reasonably be expected to be used within the next 12-month period.

**50% Statutory Prepaid Limit.** The Tax Reform Act of 1986 added a requirement that, to the extent prepaid farming expenses of a farmer using the cash method of accounting exceed 50% of deductible nonprepaid farming expenses for the taxable year, the prepaid expenses are only deductible as the purchased items are consumed [Sec. 464(f)].

For purposes of the 50% test, deductible nonprepaid farm expenses include ordinary and necessary operating expenses of the farm, interest and taxes paid and depreciation on farm equipment. Costs which must be inventoried or capitalized are not included in the 50% test.

There are two exceptions to the 50% rule where prepaid expenses may be deducted in full:

- An “eligible farmer” who fails to satisfy the 50% test due to a change in business operations directly attributable to extraordinary circumstances, including government crop diversion programs.
- An “eligible farmer” who satisfied the 50% test on the basis of the three preceding taxable years. The three-year test is computed on an aggregate basis.

An “eligible farmer” includes a person whose principal residence is on a farm, whose principal occupation is farming, or a family member of such a person [Sec. 464(f)(3)(B)].

**Example 2-5**

Joe Farmer has total farm expenses, including depreciation, on his 1998 Schedule F of \$100,000. \$70,000 of these expenses are deductible nonprepaid expenses for the year, with the remaining \$30,000 representing prepaid feed, chemicals and fertilizer purchased at year end.

The \$30,000 of "prepaid" expenses are totally deductible since they are less than 50% of the "consumed" expenses of \$70,000.

*Practice Tip:* Tax preparers should be aware of the 50% prepaid limit in advising clients regarding year-end tax planning expenditures. For active full-time farm taxpayers, the occasional encounter with the 50% limit can often be overcome by using the three-year aggregate expense exception.

**Farm Syndicate Rules**

In the case of any farming syndicate, deductions for feed, seed, fertilizer or similar farm supplies are only allowed for the tax year in which the supplies are actually used or consumed. Similarly, the cost of purchased productive poultry must be capitalized and deducted ratably over the lesser of 12 months or their useful life, and poultry purchased for resale may only be deducted in the year sold [Sec. 464].

**Definition of a Farming Syndicate.** A farming syndicate is any proprietorship, partnership, S corporation, trust or entity (other than a C corporation) engaged in farming if:

- Ownership interests have been offered for sale at any time in an offering required to be registered under federal or state securities regulations; or
- More than 35% of the losses during any period are allocated to limited partners or limited entrepreneurs.

A "limited entrepreneur" is defined as one who has an interest in the farming operation other than as a limited partner, and who does not actively participate in the management of the enterprise [Sec. 464(e)(2)].

The limited partner or limited entrepreneur definition does not apply to an individual who:

- Has actively participated for a period of at least five years in the management of the farming activity;
- Resides on the farm;
- Actively participates in the farming management or participates in the further processing of livestock raised in the business;
- Actively participates in the management of any other farming activity; or
- Is a family member (as defined in Section 267(c)(4)) of one of the above active participants [Sec. 464(c)(2)].

*Practice Tip:* The farm syndicate limitations on prepaid expenses are targeted at investors in limited partnership tax shelters involved in farm feedlots; the various “active participant” exclusions will generally except active, resident farmers from these restrictions.

See Chapter 3 for a discussion of the Section 469 passive loss rules and the Section 465 “at risk” rules. These may also present a barrier to the deduction of farm expenses.

## **DEDUCTIBILITY OF FERTILIZER EXPENSE**

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The purchase and application of fertilizer, lime, ground limestone, marl or other materials to enrich, neutralize, or condition land used in farming can be treated either as a direct expense or capitalized and deducted over the useful life of the fertilizer [Sec. 180; IRS Pub. 225, Ch. 5].

### **Current Year Deduction**

To claim current deductibility, the farm must be operated as a business and the expenditures must be made to fertilize land used in farming [Reg. Sec. 1.180-1(b)]. The expenditures for fertilizer must be of a capital nature, in the sense of having a useful life of over one year. Expenditures for the initial preparation of land are not subject to the election.

The election is made simply by claiming a deduction on the taxpayer’s return. This election is effective only for the taxable year for which the deduction is claimed [Reg. Sec. 1.180-2(a)].

The election for any taxable year may be revoked only by obtaining the consent of the district director for the district in which the taxpayer’s return is required to be filed. The request must be in writing and signed by the taxpayer or an authorized representative [Reg. Sec. 1.180-2(b)].

### **Capitalization of Expenditure**

In lieu of claiming an immediate expense deduction, the taxpayer may capitalize the fertilizer expenditures and amortize the cost over the useful life. The amortization does not need to be straight-line. Rather, the cost should be amortized based on the percentage of use or benefit each year [IRS Pub. 225, Ch. 5].

See Chapter 6 for a discussion regarding possible allocation to residual fertilizer value upon the purchase or sale of farm land.

*Practice Tip:* If a farmer’s net income is low, such that lower tax brackets, personal exemptions or itemized/standard deductions are wasted, the tax preparer should consider capitalization of current-year fertilizer expenditures. If the decision to capitalize is made, it may be helpful for the taxpayer to seek agronomy advice regarding the portion of capitalized fertilizer to be deducted each year.

## SECTION 179—ELECTION TO EXPENSE CERTAIN DEPRECIABLE ASSETS

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### General Rules

A taxpayer can elect to expense up to \$18,500 of qualified property placed in service in 1998 [Sec. 179(b)(1)]. The annual limit (\$18,500 in 1998, \$19,000 in 1999, and \$20,000 in 2000) is reduced dollar for dollar by the cost of qualified property placed in service during the year in excess of \$200,000 [Sec. 179(b)(2)]. The deduction cannot exceed the aggregate taxable income of the taxpayer derived from the active conduct of any trade or business (computed without regard to the deduction).

Under Section 179, qualified property means any Section 1245 tangible property that is:

- Subject to Section 168 depreciation, amortization, or other reasonable allowance for wear and tear;
- Acquired by purchase from an unrelated party;
- Used more than 50% in an active business;
- Not acquired by an ineligible party such as an estate, trust, or noncorporate lessor; and
- Not property used outside the U.S., property used in connection with furnishing lodging, property used by tax-exempt organizations, property used by governments and foreign persons, and air conditioners or heating units [Sec. 179(d)].

### Developments From 1991 Proposed Regulations

The Section 179 deduction is determined *without* any proration based on the period of time the Section 179 property was in service during the taxable year, or the length of the taxable year in which the property is placed in service [Prop. Reg. Sec. 1.179-1(c), PS-52-88, 3/28/91].

If property has mixed business and personal use, the portion attributable to business use is eligible for Section 179 expensing provided the business use is greater than 50%. If business use drops to 50% or less at any time during the recovery period, the excess of the Section 179 deduction over the Section 168 deduction is recaptured as ordinary income [Prop. Reg. Sec. 1.179-1(d)(1)].

Section 179 expensing is not available to trusts, estates and noncorporate lessors [Prop. Reg. Sec. 1.179-1(a)]. According to Section 179(d)(5), noncorporate lessor status occurs *unless* the term of the lease (taking into account renewal options) is less than 50% of the Section 168 class life, and in the first 12 months of the lease the Section 162 deductions incurred by the lessor (other than reimbursed amounts) exceed 15% of the rental income from the property.

The requirement that lessor expenses for the 15% test be incurred under Section 162 eliminates expenses incurred by landlords or lessors for interest expense [Sec. 163], taxes [Sec. 164], and depreciation [Sec. 167/168].

*Practice Tip:* The noncorporate lessor restriction makes eligibility for Section 179 very difficult for cash rent farm landlords who add eligible real estate improvements such as drainage tile, irrigation equipment, and additions to special purpose agricultural structures.

To qualify for Section 179 expensing, landlords would need to incur Section 162 overhead in the first 12 months of the lease which exceeded 15% of the first 12 months' rental income.

### Dollar Limitations

The dollar limitations (as well as the taxable income limit) apply to each taxpayer and not to each trade or business in which the taxpayer has an interest [Prop. Reg. Sec. 1.179-2(a)]. A husband and wife who file a joint income tax return are treated as one taxpayer in determining the amount of the annual dollar limitation (and also the taxable income limit) [Prop. Reg. Sec. 1.179-2(b)(5)].

The dollar limitation (as well as taxable income limit) applies to a partnership and S corporation as well as to each partner and S corporate shareholder [Prop. Reg. Sec. 1.179-2(c)(2) and (3)].

In determining the \$200,000 property limit for a holder of a pass-through entity, the cost of Section 179 property placed in service by the entity is *not* attributed to any partner or shareholder [Prop. Reg. Sec. 1.179-2(b)(3)].

#### Example 2-6

During 1998, Smith & Jones, a calendar-year partnership, purchases and places in service Section 179 property costing \$150,000 and elects to expense \$ 18,500 of the cost of that property.

Smith & Jones properly allocates to Smith, a calendar-year taxpayer and a 50% partner in Smith & Jones, \$9,250 of Section 179 expenses.

In applying the \$18,500 dollar limitation to Smith for 1998 on his personal Form 1040, Smith must include the \$9,250 of Section 179 expenses allocated from Smith & Jones.

However, in determining the \$200,000 property limit on Section 179 property placed in service during 1998, Smith does not include any of his proportionate cost of Section 179 property placed in service by Smith & Jones of \$75,000 ( $150,000 \times 50\%$ ).

### Taxable Income Limit

The Section 179 deduction is limited to the aggregate taxable income derived by the taxpayer or entity from the active conduct of all trades or businesses, computed before any Section 179 deduction [Prop. Reg. Sec. 1.179-2(c)(1)]. Excess deductions are carried forward indefinitely until there is sufficient taxable income.

**Active Conduct Business Income.** Active conduct is based on facts and circumstances and requires meaningful participation in the management or operations of a trade or business [Prop. Reg. Sec. 1.179-2(c)(5)(ii)].

Employees are considered to be engaged in the active conduct of the trade or business of their employment. W-2 income of one spouse may provide active business income to support the Section 179 deduction of the other spouse [Prop. Reg. Secs. 1.179-2(c)(5)(iv) and 1.179-2(c)(6)].

Section 1231 gains and losses are active business income, as is interest income from working capital of the business. The 50% self-employment tax deduction of Section 164(f) is not considered in computing active business income, and NOL carryback or carryover amounts are also excluded [Prop. Reg. Sec. 1.179-2(c)(4)].

Rental activities are also included in the definition of a trade or business if there is "active conduct." This will have the effect of increasing or decreasing active business income, even though rental assets associated with the furnishing of lodging do not qualify for Section 179.

An individual's share of pass-through income from a partnership or an S corporation will give rise to active business income or loss, if that individual meaningfully participates in the management or operations of the business (as opposed to being a mere passive investor) [Prop. Reg. Secs. 1.179-2(c)(4)(iii) and (iv), and (c)(5)(ii)].

#### Example 2-7

Brian Samuels reports as a Schedule F farm proprietor. Brian also owns and manages a 4-plex apartment building.

Brian's 1998 tax return data is as follows:

	Income before Section 179	Section 179 Property
Schedule F	\$16,500	18,500
Schedule E	5,000	—

Because Brian actively participates in the rental property, he can include net rental income in the taxable income limitation computation. Thus, Brian can take the maximum Section 179 deduction of \$18,500 in 1998 even though it exceeds his net farm income.

#### Example 2-8

Assume the same facts as in the above example, except that Brian shows a Schedule E rental loss of \$1,000.

The maximum Section 179 deduction allowable would be \$15,500 (\$16,500 Sch. F less \$1,000 Sch. E).

Brian could elect to take Section 179 expense of \$18,500 and carry forward the disallowed portion of \$ 3,000.

#### Effective Date

The proposed regulations discussed above (defining the taxable income limit and other clarifications regarding use of the Section 179 deduction) apply to property placed in service in taxable



years ending after January 25, 1993, but also are available retroactively for property placed in service after 1986 [Prop. Reg. Sec. 1.179-6].

However, the election to claim a Section 179 deduction must be made in a timely filed return; it is not available via an amended return (other than an amended return filed before the due date of the original return) [Reg. Sec. 1.179-4].

## DEPRECIATION CONSIDERATIONS

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### Depreciation Methods

The following table summarizes the depreciation methods available to farmers:

	<b>Regular Tax Purposes</b>	<b>Alt. Min. Tax Purposes (Pre-1999)</b>
Personal Property	1.5 DB over class life	
	SL over class life	
	1.5 DB over ADR midpoint life	1.5 DB over DR midpoint life
	SL over ADR midpoint life	SL over ADR midpoint life
Real Property	SL over 20, 27.5 or 39 years	SL over 25 or 40 years

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**150% Declining Balance Method.** Effective for assets placed in service after 1988, any property used in a farming business must be depreciated under the 150% declining-balance (DB) method rather than 200% DB [Sec. 168(b)(2)(B)]. As noted in the above table, for tax years before 1999, a difference still occurs between the regular depreciation calculation and the alternative minimum tax (AMT) depreciation amount, because regular depreciation is based on the modified accelerated cost recovery system (MACRS) life, while AMT depreciation uses the longer midpoint life. The 1997 Tax Relief Act eliminates the depreciation adjustment under Sec. 56(a)(1)(i) for new investments in depreciable property placed in service after 1998.

The definition of a farming business for the 150% DB requirement covers the usual crop and livestock activities, but also includes operating a nursery or sod farm, the raising or harvesting of trees bearing fruit, nuts or other crops, or ornamental trees (but excludes evergreen trees more than six years old at cutting) [Sec. 263A(e)(4)(B)].

*Practice Tips:* The 150% DB requirement applies to assets by reason of their use in a farming business, rather than their nature or class as farm equipment items. Consequently, assets such as computers, automobiles, and office furniture and fixtures are limited to the 150% DB method if used in a farming activity.

Taxpayers who are consistently subject to the alternative minimum tax may find it practical to avoid two sets of depreciation schedules by electing either 150% DB or straight line (SL) over the asset depreciation range (ADR) midpoint for personal property.

Following this chapter is a schedule of class lives and ADR midpoint lives for selected farm assets, Exhibit 2-2.

### MACRS Depreciation: Half-Year and Mid-Quarter Conventions

**Background.** The Section 168 MACRS depreciation system uses a half-year convention, which treats all property (other than realty) as placed in service at the midpoint of the tax year.

A mid-quarter convention applies (treating assets as placed in service at the midpoint of each quarter) if the aggregate basis of property placed in service during the last three months of the tax year exceeds 40% of the aggregate basis of property placed in service during the entire tax year.

#### Example 2-9

Carl Corsoy is a calendar year grain farm proprietor who acquires one asset during the year, a combine on October 1 at a cost of \$100,000.

Because the mid-quarter convention applies, Carl's depreciation in the year of acquisition, without considering Section 179, is limited to 2.68% or \$2,680 ( $\$100,000 \div 7 \text{ yr. life} \times 150\% \text{ DB} \times 1/8 \text{ yr. mid-quarter}$ ).

If Carl had acquired the combine in September, he would have been entitled to depreciation of 10.71% or \$10,710 using the half-year convention.

**Calculating the 40% Test.** In determining whether the mid-quarter convention applies, you should exclude:

- The basis of property in Section 168(f) to which MACRS does not apply (units-of-production method assets, films, video tape, standard mileage rate vehicles, etc.).
- The basis of property placed in service and disposed of in the same tax year.

You should include:

- The basis of property placed in service, disposed of, and subsequently reacquired and placed in service in the same tax year, but considering the basis only as of the latest date placed in service.
- The basis of Section 280F(d)(4) listed property (vehicles, computers, etc.) [Reg. Sec. 1.168(d)-1(b)].

**Depreciation Calculations for Property Placed in Service and Disposed of in the Same Tax Year.** Regulation Section 1.168(d)-1(b)(3)(ii) provides that no depreciation deduction is allowed when property is placed in service and disposed of in the same tax year (because deemed placed in service and disposed of on the same mid-year date), whether the half-year convention applies, or the mid-quarter convention applies.

### Example 2-10

During the year, Arnold purchases the following farm assets:

<u>Month</u>	<u>Asset</u>	<u>Cost</u>
January	Pickup truck	\$ 8,000
August	Plow	5,000
August	Rake	2,000
November	Combine	50,000

In September, Arnold sells the truck and the plow.

Because purchased and disposed of in the same year, the depreciable basis of the truck and the plow are not taken into account in determining whether the mid-quarter convention applies.

Because the combine was placed in service during the last three months of the taxable year and its basis (\$50,000) exceeds 40% of the aggregate bases of depreciable property placed in service during the taxable year (rake and combine have an aggregate basis of \$52,000), the mid-quarter convention applies to the rake and the combine.

**Definitions.** The “aggregate basis of property” for purposes of the 40% test means the sum of the depreciable basis of all items of depreciable property taken into account in applying the 40% test.

“Depreciable basis” means the basis of depreciable property for purposes of determining gain under Sections 1011 through 1024 (related to general basis rules).

“Depreciable basis” for the year property is placed in service is *after* the reduction for:

- The Section 179 \$18,500 first year deduction.
- The reduction for the nonbusiness portion of mixed use assets [Prop. Reg. Sec. 1.168(d)-1(b)(4)].

**Example 2-11**

During 1998, Sunny Brook Farms, Inc. purchased \$107,500 of 7-year MACRS equipment, with \$55,000 acquired in the second quarter and \$52,500 in the fourth quarter.

Before considering any Section 179 deduction, the assets acquired in the fourth quarter exceed the 40% test.

By electing the Section 179 allowance for fourth quarter assets, the depreciable assets for the 40% test are reduced:

	<b>Half-year Convention</b>	<b>Mid-Quarter Convention 2nd Qtr.</b>	<b>4th Qtr.</b>
Asset Cost	\$107,500	\$55,000	\$52,500
- Sec. 179	(18,500)	—	(18,500)
Depr. Basis	\$ 89,000	\$55,000	\$34,000

N/A = 38.2%

The fourth quarter additions have been reduced below 40%, so that the mid-quarter convention does not apply.

The half-year convention results in a total first year depreciation deduction, including Section 179, of \$28,032.

Conversely, if the Section 179 deduction had been claimed against second quarter assets so that the mid-quarter convention applied, the total deduction would have been \$24,794, over \$3,200 less.

*Practice Tip:* As the above example illustrates, use of the Section 179 deduction against fourth quarter additions may eliminate a detrimental mid-quarter convention (by decreasing depreciable basis of fourth quarter additions below 40%).

However, in the situation where first-quarter additions are larger than fourth-quarter additions, the mid-quarter convention may be beneficial, as illustrated in the following example:

**Example 2-12**

During 1998, Sunny Brook Farms, Inc. purchased \$175,000 of 7-year MACRS equipment, with \$100,000 acquired in the first quarter and \$75,000 in the fourth quarter. If the full Section 179 allowance were applied to fourth quarter assets, the mid-quarter convention would be avoided (i.e., \$56,500/\$165,000 = 34.2%). In this case, computing depreciation using the half-year convention produces total deductions in 1998 of \$35,261:

Section 179	\$18,500
Regular depr. $\$156,500 \times 10.71\%$	<u>16,761</u>
Total	<u>\$35,261</u>

Instead, Sunny Brook Farms, Inc. elects to apply only a portion of its Section 179 deduction to the fourth quarter, so as to remain subject to the mid-quarter convention (depreciable basis of \$67,000 = 40.6% of \$165,000):

	<b>Mid-Quarter Convention</b>		
	<u>1st Qtr.</u>	<u>4th Qtr.</u>	<u>Depr.</u>
Asset cost	\$100,000	\$75,000	\$
– Section 179	<u>(10,500)</u>	<u>(8,000)</u>	18,500
Depr. Basis	89,500	67,000	
× MACRS rate	<u>× 18.75%</u>	<u>× 2.68%</u>	
MACRS Depr.	<u>\$ 16,781</u>	<u>\$ 1,796</u>	<u>\$18,577</u>
Total Deduction			\$37,077

By selectively using the Section 179 deduction so as to remain subject to the mid-quarter convention, a larger depreciation deduction was obtained for assets acquired in the first quarter, increasing total depreciation for the year by approximately \$1,800.

Selective use of the Section 179 deduction so as to remain subject to the mid-quarter convention allows a larger depreciation deduction for assets acquired in the first quarter. This occurs since the MACRS rate for first quarter assets to which the mid-quarter convention applies is 18.75%, rather than the overall half-year convention MACRS rate of 10.71% for seven-year MACRS assets.

**Disposition of Property Subject to the Half-Year or Mid-Quarter Convention**

If property is subject to the half-year or mid-quarter convention when placed in service, it is also subject to the half-year or mid-quarter convention in the taxable year in which it is disposed of [Prop. Reg. Sec. 1.168(d)-1(c)].

**Example 2-13**

In October 1997, Emil purchases and places in service one asset, a cultivator costing \$20,000. The 40% test is satisfied and the mid-quarter convention applies.

In April 1998, prior to the end of the recovery period, Emil sells the cultivator.

The mid-quarter convention applies in determining the depreciation deduction for the cultivator in 1998.

**Lease vs. Purchase**

For income tax purposes, farm leases must be reviewed to determine if the agreement is a true lease or is, in reality, a conditional sales contract.

**True Lease.** Lease payments for the use of the equipment are deductible as a farm expense.

**Conditional Sales Contract.** If the taxpayer acquired or will acquire title to or equity in the equipment, the lease payments are considered payments (principal and interest) for the purchase of the equipment. The equipment is capitalized and depreciated [IRS Pub. 225, Ch. 5].

**Example 2-14**

Paul leases a tractor from the local farm equipment dealer who both sells and leases equipment. The lease payments and the option purchase price equal the sales price plus interest. Paul is responsible for maintenance and repairs of the tractor, and has the risk of loss.

For tax purposes, the lease is considered a conditional sales contract. The lease payments are not deductible as rent, but Paul may deduct depreciation, interest, repairs, insurance and other business expenses.

The intent of the parties and the facts and circumstances existing at the inception of the agreement determine whether an agreement is a true lease or a conditional sales contract. An agreement is normally considered a conditional sales contract, absent any compelling and persuasive facts to the contrary, if any of the following is true:

- The agreement applies part of each payment toward an equity interest to be received;
- Title to the property is transferred after payment of a stated number of required payments;
- Payments made over a short period of time equal an amount that is a large part of the actual purchase price of the property;
- Rent is much more than the current fair rental value for the property;
- The option to buy the property is small compared to the expected value of the property at the time of the anticipated option exercise, determined at the time of entering into the original agreement;

- The option to buy the property is small compared to the total amount required to be paid under the lease; or
- The lease designates some part of the payments as interest, or part of the payments are easily recognized as interest [IRS Pub. 225, Ch. 5].

## **SOIL AND WATER CONSERVATION EXPENDITURES**

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### **Deductible Conservation Expenses**

A taxpayer engaged in farming is permitted to deduct expenses which otherwise may be capital in nature for soil and water conservation and the prevention of farmland erosion [Sec. 175(a)]. Conservation expenses include, but are not limited to:

- The treatment or movement of earth, such as leveling, conditioning, grading, terracing, contour furrowing, or restoration of fertility;
- The construction, control, and protection of diversion channels, drainage ditches, irrigation ditches, earthen dams, watercourses, outlets, and ponds;
- The eradication of brush; and
- The planting of windbreaks [Sec. 175(c)(1)].

Soil and water conservation expenses are deductible only if they are consistent with a plan approved by the Soil Conservation Service (SCS) of the Department of Agriculture. If no such plan exists, the expenses must be in conformity with a plan of an applicable state agency [Sec. 175(c)(3)].

A 1995 District Court case denied depreciation and investment credit to taxpayers for trees and bushes planted on their farm as a windbreak. Although the trees and bushes were planted under a soil conservation program and were intended to reduce moisture evaporation and soil erosion, the court found the trees did not produce revenue and accordingly were a part of the farm realty rather than depreciable business assets of the farm. The ruling did not directly address deductibility of the amounts as soil and water conservation expenditure [*Gary Everson v. U.S.*, CV 93-140-BLG-JDS, 95-1 USTC ¶50,150 (DC Mont. 1995)].

**SCS Individual Site Plans.** These are issued individually to farmers who request assistance from SCS to develop a conservation plan designed specifically for their farmland.

**SCS County Plans.** These include a listing of farm conservation practices that are approved for the county where the farmland is located. Expenses for conservation practices not included on the SCS county plans are deductible only if the practice is a part of an individual site plan. Individual site plans can be obtained from SCS offices and comparable agencies.

**Comparable State Agency Plans.** These are plans approved by state agencies and may be approved individual site plans or county plans [IRS Pub. 225, Ch. 6].

## Current Year Deduction of Expenditures

The deduction for soil and water conservation expenditures cannot exceed 25% of gross income from farming. Any deduction in excess of the 25% limit is carried over to later years. The deductible amount in any carryover year cannot exceed 25% of farm gross income in that year [Sec. 175(b)].

### Example 2-15

In 1997, Al Summers had gross income of \$18,000 from two farms. During the year, Al made \$5,000 of qualifying soil and water conservation expenditures for one of the farms.

Al's deduction is limited to 25% of \$18,000, or \$4,500. The excess \$500 (\$5,000-\$4,500) is carried over to 1998 and added to qualified soil and water conservation expenses made in that year, subject to the limit of 25% of Al's gross income from farming in 1998. Any excess expenses over the limit in that year are carried to 1999 and later years.

**Gross Income From Farming.** Farm gross income includes income from land used in farming other than the specific parcel involved in the conservation expenditures. It also includes income from the production of crops and other agricultural products, including gain from livestock held for dairy, breeding or draft, but does not include gains from sales of machinery or land [Reg. Sec. 1.175-5(a)(2)].

**Making the Election.** Electing to deduct soil and water conservation expenses in the year incurred is accomplished in one of two ways:

- For the first year conservation expenses are paid or incurred, the expense may be claimed as a deduction on the tax return.
  - Once this choice is made, consent from the District Director of the Internal Revenue Service must be obtained to change.
  - If these expenses are not deducted for the first year in which they are paid or incurred, the expenses must be capitalized.
- If these expenses were capitalized in previous years and the taxpayer wants to claim current-year expenses as a deduction on the tax return, consent for the change must be obtained from the District Director [Sec. 175(e); Reg. Sec. 1.175-6(d)].

## Landlord Eligibility

A landlord who receives a rental, either in cash or in shares of production, is considered engaged in the business of farming and eligible for Section 175 deductions if the rent is based on farm production.

A landlord who receives a fixed rental without reference to production is ineligible, unless he participates to a material extent in the operation or management of the farm [Reg. Sec. 1.175-3].



### **Ineligible Expenditures**

The purchase, construction, installation or improvement of property which is depreciable is not eligible to be treated as deductible soil and water conservation expenditures [Sec. 175(c)(1)(A)].

Examples of ineligible depreciable improvements include tanks, reservoirs, pipes, conduits, canals, dams, wells or pumps composed of masonry, concrete, tile, metal or wood, but earthen items serving these functions remain eligible [Reg. Sec. 1.175-2(b)(1)].

Expenditures in connection with the draining or filling of wetlands or land preparation for center pivot irrigation systems are ineligible [Sec. 175(c)(3)(B)].

Land clearing expenditures are ineligible. Former Section 182 allowed a limited deduction for land clearing, but this was repealed by TRA '86. Land clearing expenditures which prepare land for farming must now be added to land basis.

**Expense Items.** Section 175 does not apply to expenses deductible under other Code sections, such as expenses for repairs or maintenance under Section 162 (e.g., removal of sediment from a ditch) [Reg. Sec. 1.175-2(b)(2)].

However, Section 175 does apply to expenses to produce vegetation to prevent erosion, such as dirt moving, seed and fertilizer, and costs for gully stabilization [Reg. Sec. 1.175-2(b)(2)].

### **Assessments of Soil or Water Conservation Districts**

In general, assessments levied by soil, water or drainage districts are eligible under Section 175 if the expenditure would have qualified if paid by the farmer directly [Sec. 175(c)(1)].

**Assessments for Depreciable Property.** Assessments by conservation and drainage districts for depreciable improvements are also deductible, provided that the taxpayer's share of the assessment does not exceed 10% of the total assessment levied upon all members [Sec. 175(c)(1)].

To the extent a district's assessment for depreciable improvements to a taxpayer exceeds 10% of the total assessment to all members, the excess is treated as a capital item that adds to the basis of farmland [IRS Pub. 225, Ch. 6].

**10-Year Spread on Deductible Depreciable Assessment.** If a taxpayer pays or incurs a depreciable assessment which is in excess of 10% of the taxpayer's assessed share of depreciable improvements, and if the excess is over \$500, the entire excess must be deducted ratably over each of the nine succeeding tax years [Sec. 175(f)(1)].

**Example 2-16**

Max pays an assessment of \$2,400 to his soil conservation district, of which \$1,500 is for drainage ditch maintenance and \$900 is for dragline equipment. The total dragline equipment assessment to all district members is \$8,000.

Max is limited to a Section 175 deduction of \$800 ( $10\% \times \$8,000$ ) for his share of the equipment; the other \$100 amount adds to his land basis. Because the amount paid toward deductible depreciable equipment of \$800 exceeds 10% of the total, or \$80, the excess of \$720 must be spread ratably over nine years (or \$80 per year). Max will deduct \$1,580 in the first year, and \$80 each year thereafter for nine years.

If land is disposed of during the nine-year period of deductibility of a depreciable assessment, the undeducted balance as of the beginning of the tax year is added to the basis of the land [Sec. 175(f)(2)].

If the death of the taxpayer occurs during the 9-year period, the undeducted balance is fully deductible in the year of death [Sec. 175(f)(3)].

**EXHIBIT 2-1**

**Biebl, Ranweiler, Christiansen, Meyer, Thompson & Co. Chartered**  
**Certified Public Accountants**

FARM WORKSHEET - 1997

NAME: \_\_\_\_\_

Please round to whole dollars

**FARM INCOME**

**Sale of livestock & other items purchased:**

Feeder pigs - sale price  
 Feeder cattle - sale price  
 Other \_\_\_\_\_ - sale price

(Report breeding livestock sales on P.3)

Sale Price

Cost

		( )
		( )
		( )

**Sale of livestock & produce raised:**

Steers & calves  
 Feeder & butcher hogs  
 Dairy products

Soybeans  
 Corn  
 Vegetables  
 Other grain \_\_\_\_\_

Value of commodities to employees as salary  
 Other \_\_\_\_\_


**Other farm income: (attach all Forms 1099)**

Patronage dividends (100%)  
 Government/FSA payments - disaster \_\_\_\_\_  
 (See questions on page 4)  
 other \_\_\_\_\_

Total Government/FSA

CCC loans elected as income  
 CCC loans forfeited (loan method)  
 Crop insurance proceeds (See questions on page 4)  
 Custom machine work  
 Federal gas tax refund  
 Minnesota gas tax refund  
 Property tax refund  
 Personal consumption  
 Other: \_\_\_\_\_


**Total Income**

\$ \_\_\_\_\_

**FARM EXPENSES**

Food for hired help & business

entertainment

less 50%

( \_\_\_\_\_ )

\_\_\_\_\_

Vehicle expense from Page 4

\_\_\_\_\_

Chemicals

\_\_\_\_\_

Custom work (machine hire)

\_\_\_\_\_

Employee benefits-medical insurance

\_\_\_\_\_

-medical bills paid

-insurance reimbursement received

( \_\_\_\_\_ )

\_\_\_\_\_

Feed purchased

\_\_\_\_\_

Fertilizer

\_\_\_\_\_

Freight and trucking

\_\_\_\_\_

Gas, fuel, oil & LP gas for farm use

(exclude amounts in vehicle expense)

\_\_\_\_\_

Farm insurance (incl. crop ins.)

less residence portion

( \_\_\_\_\_ )

\_\_\_\_\_

Interest

\_\_\_\_\_

Office Use Only	
Mortgage (paid to banks	_____
Other	_____

Labor: Cash wages (per Forms W-2)

Commodity wages (per Forms W-2)

\_\_\_\_\_

Rent: machinery & equipment

\_\_\_\_\_

land

\_\_\_\_\_

Repairs & maintenance

\_\_\_\_\_

Seed

\_\_\_\_\_

Storage

\_\_\_\_\_

Supplies purchased

\_\_\_\_\_

Real estate taxes

less residence portion

( \_\_\_\_\_ )

\_\_\_\_\_

Payroll taxes paid during 1997

\_\_\_\_\_

Utilities

less personal use portion

( \_\_\_\_\_ )

\_\_\_\_\_

Telephone:

Farm business long distance phone

tolls only and farm cell phone

\_\_\_\_\_

Veterinary, breeding & medicine

\_\_\_\_\_

Legal & accounting

less personal

( \_\_\_\_\_ )

\_\_\_\_\_

Farm dues & publications

\_\_\_\_\_

Casual labor

\_\_\_\_\_

Other

\_\_\_\_\_

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\_\_\_\_\_

**Total Farm Expenses**

\$ \_\_\_\_\_



**VEHICLE INFORMATION** (pickups and cars only):

	<u>Vehicle #1</u>	<u>Vehicle #2</u>	<u>Vehicle #3</u>
Description	_____	_____	_____
Do you have evidence to support the business use?	<input type="checkbox"/> yes <input type="checkbox"/> no	<input type="checkbox"/> yes <input type="checkbox"/> no	<input type="checkbox"/> yes <input type="checkbox"/> no
If yes, is the evidence written (log book)?	<input type="checkbox"/> yes <input type="checkbox"/> no	<input type="checkbox"/> yes <input type="checkbox"/> no	<input type="checkbox"/> yes <input type="checkbox"/> no
<b>MILEAGE INFORMATION:</b>			
+ Total business miles	_____	_____	_____
+ Total personal miles	_____	_____	_____
= Total miles driven	_____	_____	_____
% of business use	_____ %	_____ %	_____ %
<b>Operating Expenses:</b>			
Gas	\$ _____	\$ _____	\$ _____
Repairs	\$ _____	\$ _____	\$ _____
Insurance	\$ _____	\$ _____	\$ _____
License	\$ _____	\$ _____	\$ _____
Other	\$ _____	\$ _____	\$ _____
Total	\$ _____	\$ _____	\$ _____
(Office use only)			
Total x business %	_____ %	_____ %	_____ %
= Business deduction	\$ _____	\$ _____	\$ _____
Vehicle Total (to Page 2)			\$ _____

**MISCELLANEOUS QUESTIONS:**

**Crop Insurance Proceeds and USDA Disaster Payments:**

If you received crop insurance or USDA disaster payment proceeds in 1997, please complete the following (attach Form 1099):

Crop destroyed: \_\_\_\_\_  
 Date of loss: \_\_\_\_\_  
 Cause: \_\_\_\_\_  
 Insurance Company: \_\_\_\_\_  
 Proceeds: \$ \_\_\_\_\_

Crop destroyed: \_\_\_\_\_  
 Date of loss: \_\_\_\_\_  
 Cause: \_\_\_\_\_  
 Insurance Company: \_\_\_\_\_  
 Proceeds: \$ \_\_\_\_\_

**Gas Gallons:**

Non-highway gallons of gas purchased in 1997 on which federal tax was paid:

Federal  
 \_\_\_\_\_ gallons gas  
 \_\_\_\_\_ gallons gasohol

Minnesota (1/1/97 to 6/30/97)\*  
 \_\_\_\_\_ gallons gas  
 \_\_\_\_\_ gallons gasohol

\* We must have original invoices to apply for Minnesota refund.

**Futures Contracts:**

If you have futures transactions, please bring your monthly summary statements for the year.

**NOTE: Please complete the enclosed Client Tax Information Worksheet in addition to this sheet.**

## EXHIBIT 2-2

### SELECTED FARM ASSETS—CLASS LIVES AND ADR MIDPOINT LIVES

Asset	Property Class and Recovery Period	
	Class Life	ADR Midpoint Life
Airplane	5	6
Auto (farm share)	5	5
Calculators, copiers & typewriters	5	6
Cattle (dairy or breeding)	5	7
Communication equipment	7	10
Computers and peripheral equipment	5	5
Cotton ginning assets	7	12
Farm buildings (general purpose)	20	25
Fences (agricultural)	7	10
Goats (breeding or milk)	5	5
Grain bin	7	10
Greenhouse (single-purpose structure)	10	15
Helicopter (agricultural use)	5	6
Hogs (breeding)	3	3
Horses (nonrace, 12 years of age or less)	7	10
Horses (nonrace, over 12 years of age)	3	10
Logging equipment	5	6
Machinery (farm)	7	10
Office equipment (other than calculators, copiers, or typewriters)	7	10
Office fixtures	7	10
Office furniture	7	10
Paved lots	15	20
Property with no class life	7	12
Race horses more than 2 years old	3	12
Race horses 2 years old or less	7	12
Rental property (nonresidential)	39	40
Rental property (residential)	27.5	40
Sheep (breeding)	5	5
Single-purpose agricultural structure	10	15
Single-purpose horticultural structure	10	15
Tile (drainage)	15	20
Tractor units for use over the road	3	4
Trailer for use over the road	5	6
Trees or vines bearing fruit or nuts	10	20
Truck (heavy duty, general purpose)	5	6
Truck (light, less than 13,000 lbs.)	5	5

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## **CHAPTER 3**

### **UNIQUE ISSUES IMPACTING FARM TAXATION**

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#### **OVERVIEW**

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An understanding of this chapter will enable you to:

- Apply the passive activity rules as they relate to farmers;
- Identify situations in which the at-risk rules apply to farmers;
- Calculate the basis of a replacement asset in an involuntary conversion;
- Deal with installment sale issues, and identify potential issues associated with deferred commodity sales;
- Recognize when to apply the doctrine of constructive receipt; and
- Determine the situations in which payment of rent to a spouse is advantageous.

#### **INTRODUCTION**

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All trades and businesses seem to have several unique income tax considerations. However, when one surveys the critical issues in taxation, such as passive loss rules, at-risk limits, and installment sale arrangements, inevitably one encounters specific exceptions carved out for farmers and ranchers. In some cases, such as with the passive loss regulations, the exceptions are generally punitive. On the other hand, in many other instances, as with installment sales, Congress has reserved special benefits for farmers and ranchers. This chapter will discuss various tax considerations which tax preparers must be familiar with in working with their farm clients.

#### **PASSIVE LOSS REGULATIONS AND THE FARMER**

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##### **Background**

The Tax Reform Act of 1986 placed limitations on the ability of a taxpayer to use deductions from passive activities against income from other sources. These passive loss rules apply to individuals, trusts, estates, personal service corporations, and, to a limited extent, closely held C corporations [Sec. 469(a)(2)].

A passive activity is any trade or business in which the taxpayer does not materially participate, or any rental activity [Sec. 469(c)].



**Basic Operating Rules.** Deductions from passive activities are allowed only to the extent of income from passive activities. Passive deductions which are not allowed in the current year are carried forward indefinitely until there is passive income. If a passive activity is disposed of, any suspended loss from that activity is allowed in full.

Up to \$25,000 of losses from rental real estate activities (but not other rental activities) may be deductible annually against other nonpassive income, subject to active participation on the part of the taxpayer and a phase-out of the privilege for higher income taxpayers.

### **Determining Material Participation**

The passive activity rules make it necessary to determine if sole proprietors, partners or stockholders in an S corporation materially participate in the trade or business.

The statute simply states that a taxpayer materially participates if involvement is regular, continuous and substantial [Sec. 469(h)(1)]; however, the Code also directs the Treasury to issue regulations as may be necessary, including regulations which specify what constitutes material participation [Sec. 469(l)(1)].

Temporary Regulation Section 1.469-5T establishes guidelines to determine material participation. Under these guidelines, an individual materially participates in an activity if any one of seven tests are met:

- The individual participates in the activity for more than 500 hours during the year.
- The taxpayer's participation in the activity constitutes substantially all of the participation by all individuals in the activity.
- The taxpayer's participation is more than 100 hours during the year, and no other individual participates more hours than the taxpayer.
- The taxpayer's annual participation in all significant participation activities is more than 500 hours. (A "significant participation activity" is generally one that the taxpayer participates in for more than 100 hours during the year.)
- The taxpayer materially participated for any five taxable years during the ten immediately preceding taxable years.
- If the activity is a personal service activity, the taxpayer materially participated in the activity for any three taxable years preceding the current taxable year. (Personal service includes the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor.)
- Based on all facts and circumstances, the taxpayer participates on a regular, continuous, and substantial basis during the year.
  - Future regulations are to provide further guidance for this test.
  - However, the temporary regulations indicate that, if an individual participates in an activity for 100 hours or less during the year, the "facts and circumstances" test is not available to qualify for material participation [Reg. Sec. 1.469-5T(b)(2)(iii)].

Also, services in the management of the activity are not to be taken into account for this test unless no person (other than the taxpayer) who performs services in connection with the activity receives fees or compensation, and no individual performs services that exceed (by hours) the amount of services performed by the individual [Reg. Sec. 1.469-5T(b)(2)(ii)].

**Example 3-1**

Don Johnson is a 25% partner in a farm partnership, but his only involvement in the operations is one meeting per year with the other partners. The partnership produces a \$10,000 loss in 1998.

Because Don's participation in the activity does not meet any of the above criteria, this loss is passive and is not allowed unless there is other passive income within his return for 1998.

**Example 3-2**

Terry Treflan and his son have been actively farming together for about 15 years, using an S corporation in which both are stockholders and material participants.

As of the beginning of 1998, Terry retires as an officer and employee, sells most of his stock to his son, and begins drawing Social Security retirement benefits.

Even though Terry no longer materially participates in the farming business as of the beginning of 1998, he is treated as materially participating for the taxable years 1998 through 2002 under Test 5 above (he materially participated in the activity for five taxable years during the ten taxable years that immediately precede each of those years).

**Example 3-3**

Dr. Karl owns a 10% limited partnership interest in an entity located in a distant state that feeds and sells cattle.

The general partner periodically mails Dr. Karl a letter explaining proposed actions, such as decisions on what kind and quantity of feed to purchase, how often to feed cattle, and when to sell cattle, and asks Dr. Karl and the other partners to indicate a decision with respect to each question.

The general partner receives a fee for managing the operation, although all major decisions are made by Dr. Karl and the other limited partners.

Dr. Karl does not materially participate under Tests 1 through 6. Because Dr. Karl's only participation is in the management of the activity and because this occurs while another individual receives a fee or compensation for services in the activity, Dr. Karl is also treated as not materially participating under Test 7.

### Other Participation Definitions

Material participation is counted only for periods when the individual has an ownership interest in the activity.

Work done as an investor, such as reviewing financial operations, preparing summaries for personal use, and monitoring finances in a nonmanagerial capacity, does not constitute material participation.

Participation by one spouse is considered to be material participation by the other spouse [Reg. 1.469-5T(f)].

### The \$25,000 Special Rental Realty Allowance

A special allowance exists for rental real estate activities, allowing the first \$25,000 of net passive losses from rental realty to offset nonpassive income [Sec. 469(i)].

The \$25,000 deductible rental realty allowance phases out for taxpayers with higher adjusted gross incomes. The \$25,000 amount is reduced by 50% of the amount by which the taxpayer's "modified adjusted gross income" exceeds \$100,000. Accordingly, as a taxpayer's modified AGI increases from \$100,000 to \$150,000, the \$25,000 rental realty loss allowance decreases from \$25,000 to zero. "Modified AGI" is AGI computed without regard to taxable Social Security and railroad retirement benefits, deductible IRA contributions, and any passive activity losses [Sec. 469(i)(3)].

To qualify for the \$25,000 allowance, the taxpayer must "actively participate" during the tax year in which the loss arises. The active participation standards are less stringent than the standards for material participation. The taxpayer must participate in a significant way such as making management decisions or arranging for others to perform services for the rental activity. Also, the taxpayer must have at least a 10% (by value) ownership interest in the activity, and this interest may not be that of a limited partner [Sec. 469(i)(6)].

The \$25,000 loss privilege also applies to the rehabilitation tax credit and low-income housing credit, by allowing such credits to annually offset the tax attributable to up to \$25,000 of income. However, there is no active participation requirement for rehab or low-income housing credit activities. Also, the AGI phase-out does not apply to investors in low-income housing projects, and does not begin until \$200,000 for investors in rehabilitation tax credit activities [Sec. 469(i)(3)(B) and (C)].

Cash rentals of farm buildings (if at least 30% of unadjusted basis is depreciable) are rental real estate arrangements which are eligible for the \$25,000 rental loss privilege.

#### Example 3-4

Stan Smith owns a number of farm buildings which are rented to a neighboring farmer. Each year, Stan negotiates the terms of the rental agreement and is responsible for any necessary repairs to the property.

Stan actively participates in the activity and any loss from this activity is eligible for the \$25,000 rental realty allowance.

An apparent conflict exists regarding the passive categorization of crop-share rental arrangements. If an activity is categorized as rental, it is always passive; if characterized as a trade or business, it is passive only if the taxpayer does not materially participate. The Temporary Regulations conclude that a crop-share arrangement constitutes a joint venture between the landlord and tenant. As such, a crop-share arrangement is not considered a rental activity on the part of the landlord [Reg. Sec. 1.469-1T(e)(3)(viii), Example (8)]. Presumably, this means that a landlord receiving crop-share rents is conducting a business activity, and must use the material participation tests to determine passive vs. active status. Also, the \$25,000 rental realty loss privilege would not be available.

The instructions for IRS Form 4835, "Farm Rental Income Crop Shares," are in direct conflict with the regulations. The approach of the IRS instructions for Form 4835 is that a crop share arrangement is a rental activity. The instructions state that, if a loss is reported and the taxpayer actively participates, the taxpayer "may be able to deduct up to \$25,000 of losses from all rental real estate activities."

### Rules Preventing Conversion of Portfolio or Business Income into Passive Income

**Rental of Nondepreciable Property.** The preamble to the 1988 Regulations states the intent is to prevent taxpayers who desire passive income from replacing their portfolio investments with rental property that shares many of the investment characteristics of traditional portfolio investments [Reg. Sec. 1.469-2T(f); T.D. 8175 of 2-19-88].

Net passive income from rental property is considered *not* from a passive activity if less than 30% of the unadjusted basis of the property is depreciable [Reg. Sec. 1.469-2T(f)(3)].

This conversion of passive income to portfolio income is effective for tax years beginning in 1988 and after [Reg. Sec. 1.469-11T(a)(2)]. This conversion rule only applies if there is net income from the rental of the activity; if there is a loss, the loss remains in passive status.

#### Example 3-5

Joe Corsoy is an executive who owns several tax shelter limited partnerships with suspended passive losses.

Joe purchased farm land from his father several years ago for a cost of \$100,000, with about \$10,000 of the original cost assignable to depreciable property (fencing and drainage tile). Joe leases this farm land to his brother.

Joe's income from the cash rent of this land to his brother is recharacterized as portfolio income in 1988 and after because less than 30% of the unadjusted basis is depreciable property.

**Self-Rented Property.** Net rental income is treated as *not* from a passive activity if it is derived from rent for use in a business activity in which the taxpayer materially participates [Reg. Sec. 1.469-2T(f)(6)].

An individual leasing farm land to a partnership or an S corporation in which the taxpayer materially participates will find that this Regulation converts the rental income into business income for purposes of passive loss rules.

For the leasing of land by an individual to a closely held C corporation, the position of the IRS in an April 1994 internal reference guide used by the IRS in auditing passive activity losses is that passive income does *not* occur. However, the reference guide explains the recharacterization rules do not apply to rental activities involving C corporations for tax years before the effective date of the proposed passive activity regulations (i.e., tax years beginning before May 10, 1992).

A special grandfather clause eliminates the conversion of net self-rental income into business income, if the lease is pursuant to a written binding contract entered into before February 19, 1988 [Reg. Sec. 1.469-11T(a)(2)(ii)].

## **AT-RISK RULES AND THE FARMER**

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### **Background**

Losses from certain activities, including farming, may be limited under the "at risk" rules to the amount of the taxpayer's risk of economic loss in the activity [Sec. 465; IRS Pub. 925]. Losses limited under the at-risk rules are suspended and carried over to future years until the taxpayer's "at-risk amount" increases.

Taxpayers subject to the at-risk rules include:

- Individuals;
- Trusts and estates; and
- A "C corporation" if it meets the stock ownership test for personal holding company status [Sec. 465(a)(1)].

### **Activities Subject to the At-Risk Limits**

The at-risk rules apply to all activities engaged in by the taxpayer in carrying on a trade or business, or for the production of income [Secs. 465(c)(1) and 465(c)(3)(A)].

The at-risk rules apply to any taxpayer who is engaged in farming as a trade or business or for the production of income.

A farm includes all property involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity, including animals [Reg. Sec. 1.465-43(d)].

Farming was one of the original activities subject to the at-risk rules, prior to the 1978 change expanding the rules to all business activities. Each farming activity of a taxpayer is to be treated as a separate activity in testing the at-risk limits [Sec. 465(c)(2)]; however, aggregation of multiple activities which constitute a trade or business is permitted if the taxpayer actively participates in management [Sec. 465(c)(3)].

### Determining the Amount At Risk

The taxpayer's at risk amount is the sum of:

- Money contributed by the taxpayer to the activity;
- The adjusted tax basis of assets contributed by the taxpayer to the activity; and
- Amounts borrowed for use in the activity, to the extent that the taxpayer
  - Is personally liable for the repayment; or
  - Has pledged property, other than property used in the activity, as security for the borrowed amount, limited to the net fair market value of the pledged property [Sec. 465(b)].

*Practice Tip:* Note that pledged property retained outside of the activity will cover an at-risk loan amount to the extent of the property's fair-market value, whereas property contributed to the activity only provides an increase to the extent of adjusted tax basis.

### Amounts Not At Risk

Amounts borrowed from any person who has an interest in the activity, or from a person related to someone (other than the taxpayer) having an interest in the activity, are not at risk [Sec. 465(b)(3)(A)].

Nonrecourse loans and loans protected by guarantees, stop-loss arrangements and other such limits are not at risk [Sec. 465(b)(4)].

In determining whether a lender has an interest in an activity, either a capital interest or an interest in net profits is considered. However, an interest in gross receipts is not considered an interest in the activity [Reg. Sec. 1.465-8(b)].

#### Example 3-6

Frank is a young grain farmer who leases a parcel of land on a crop-share arrangement from Harold, an elderly neighbor. The lease calls for Harold to receive 40% of the gross crop production. To assist Frank in getting started in farming, Harold has loaned \$40,000 to Frank on a recourse note secured by Frank's machinery.

Because Harold's interest in Frank's farming activity is limited to a share of gross receipts, Frank is considered to be fully at risk for the funds borrowed from Harold for use in his farming activity (i.e., Harold is not considered to have a prohibited interest in Frank's farming activity under the at-risk rules).

## Suspended Losses

Losses limited due to the at-risk rules are suspended and treated as a deduction allocable to the activity the following year. The loss is subject to the same at-risk tests the next year. Part or all of the suspended loss may be used if the activity generates income. The suspended loss may also be deductible if the amount at risk increases.

A suspended loss can be carried over indefinitely, and can be used to offset any gain on disposition.

**Completing the Tax Return.** Question 37 on the bottom of Schedule F must be completed on each Schedule F with a loss. If a portion of the investment is not at risk, a Form 6198 must be completed and attached to the return. A copy of Form 6198, At-Risk Limitations, follows this chapter as Exhibit 3-1.

## INVOLUNTARY CONVERSIONS

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### Background

While gain or loss on the sale or disposition of property generally must be recognized, Section 1033 allows gains realized from certain involuntary conversions to be recognized or deferred under election. An involuntary conversion results from the property's destruction, theft, seizure or condemnation. Special involuntary conversion rules apply to livestock sold early because of drought, flood or other weather-related conditions, and to livestock sold or exchanged because of disease.

In order to defer the gain, the taxpayer must both make the necessary election and timely purchase of qualified replacement property. Taxpayers cannot postpone reporting gain on an involuntary conversion that occurs after June 8, 1997, if they acquire replacement property from a related party and their total realized gain from involuntary conversions during the year is more than \$100,000 [Sec. 1033(i), as amended by the 1997 Taxpayer Relief Act].

### Qualified Replacement Property

The replacement property must be similar or related in use or service. The replacement property should substantially continue, and not alter, the nature and character of the taxpayer's investment [Reg. Sec. 1.1033(a)-2].

Examples of qualified replacement property include:

- Breeding cattle replacing buffalo of the same sex [PLR 7903064].
- Breeding, draft or dairy livestock replacing breeding, draft, or dairy livestock, respectively [Reg. Sec. 1.1033(e)-1(d)].
- Land that needed clearing before use as a building site replacing cleared building site [*Gaynor News Co., Inc. v. Comm.*, 22 TC 1172, 1954].
- A rental building replacing a ranch [*E. Braley*, 14 BTA 1153].

Examples of property that would not qualify as replacement property include:

- Farm tractor replaced by a farm truck [Rev. Rul. 71-575, 1971-2 CB 61].
- Breeding or dairy animals replacing draft animals [Reg. Sec. 1.1033(e)-1(d)].

### The Replacement Period

The purchase of replacement property must occur within two years after the close of the first year in which any gain is realized (three years for condemnations of real estate used in a business or for investment) [Secs. 1033(a)(2)(B) and 1033(g)(4)].

Special rules apply for a principal residence damaged in a Presidentially declared disaster area, including an extension of the replacement period to four years after the close of the first year in which any gain is realized [Sec. 1033(h)].

The replacement period can be extended by application to the IRS District Director if reasonable cause can be shown to the IRS for not being able to replace within the two-year period [Reg. Sec. 1.1033(a)-2(c)(3)].

#### Example 3-7

Charlie Connors is a wheat farmer whose combine was completely destroyed by fire on October 14, 1998.

The tax basis of the combine was \$25,000 and Charlie's insurance paid him \$35,000 on November 12, 1998 resulting in a \$10,000 gain. Charlie replaced the combine for \$50,000 on November 30, 1998.

The \$10,000 gain is not taxable, but rather reduces the basis of the replacement property. Charlie's deadline for replacement of the combine would have been December 31, 2000, two years after the close of the year in which the gain is realized.

**The Election.** The election must be made by the time for filing the return (including extensions) for the first taxable year to which the election is to apply [Reg. Sec. 1.1033(a)-2(c)(2)]. An example of the election follows this chapter as Exhibit 3-2.

*Practice Tip:* If an election is filed to defer the gain and the property is not replaced within the two-year replacement period, an amended return for the year in which the insurance proceeds were received must be filed to report the gain.

### Livestock Destroyed by Disease

If livestock are destroyed, sold or exchanged because of disease, the transaction qualifies for Section 1033 involuntary conversion treatment [Sec. 1033(d)]. Livestock which are sold or exchanged because they are diseased or have been exposed to disease, and would not otherwise have been sold at that time, are considered eligible [Reg. Sec. 1.1033(d)-1(a)].



### Examples of "diseased livestock":

- The disease need not be of epidemic proportions [Rev. Rul. 61-216, 1961-2 CB 134].
- The destruction of honeybees because of the use of pesticides near the beehives qualified as an involuntary conversion [Rev. Rul. 75-381, 1975-2 CB 25], but the sale of a herd of beef cattle which developed the dwarf gene did not qualify because dwarfism in beef cattle is not a disease [Rev. Rul. 59-174, 1959-1 CB 203].

The election statement and tax return disclosure requirements for replacement of diseased livestock are the same as any involuntary conversion except the taxpayer must include a recital of the evidence that livestock were destroyed or sold because of disease [Reg. Sec. 1.1033(d)-1(b)].

### Livestock Sold Due to Drought, Flood, or Other Weather-Related Condition

The sale of livestock (other than poultry) held by a taxpayer for draft, dairy or breeding purposes in excess of the number which would have been sold under the taxpayer's usual business practice is treated as an involuntary conversion if the early sale occurred solely on account of drought, flood, or other weather-related condition that resulted in the area being designated as eligible for federal assistance [Sec. 1033(e)]. Prior to the addition of flood or other weather-related conditions as the cause of forced sale by the 1997 Tax Relief Act (effective for sales after 1996), only forced sales due to drought were eligible for involuntary conversion treatment. The sale or exchange of the livestock must be solely on account of drought or other conditions which affected the water, grazing or other requirements of the livestock, but it is not necessary that the livestock have been held in a drought or flood area, or that the actual sale occur in a drought or flood area [Reg. Sec. 1.1033(e)-1(b)].

The involuntary conversion tax treatment is limited to the livestock sold in excess of the number that would have been sold under the taxpayer's usual business practice [Reg. Sec. 1.1033(e)-1(c)].

#### Example 3-8

Hans Becker is a dairy farmer who normally culls and sells 10 dairy cows annually. Because drought conditions severely limited the hay and alfalfa supply in the area, Hans sells 25 dairy cows this year, and also sells early an extra 20 raised heifers (raised for resale) which would have been sold in the next year.

Hans may elect Section 1033 involuntary conversion treatment for 15 dairy cows, deferring the gain against the basis of the first 15 dairy or breeding cows purchased within the next two tax years. The extra 20 resale animals sold early are not eligible for involuntary conversion treatment because they were not held for draft, dairy or breeding purposes.

*Practice Tip:* In the preceding example, the early sale of the 20 heifers would be eligible for the one-year income deferral of Section 451(e); see Chapter 1 for a discussion of these rules. The early sale of the 15 extra dairy cows in the preceding example also would be eligible for the Section 451 one-year income deferral, but this is generally less advantageous where Section 1033 rollover treatment is available.

By electing Section 1033, the gain from the animals sold early results in a basis reduction of the replacement livestock, so that the deferred gain is effectively recognized by way of reduced depreciation over the subsequent five-year period. However, Section 1033 will not be available where the animals sold early are replaced by raised stock from within the taxpayer's own production (i.e., where a purchase of replacement dairy or breeding stock does not occur).

### **Reporting Drought, Flood, or Other Weather-Related Condition Sales of Productive Livestock**

The tax return in which any gain is first realized should include:

- Evidence of the drought, flood, or other weather-related conditions which caused the early sale;
- Computation of the gain realized;
- Number and kind of livestock sold; and
- Number of each kind of livestock which would have been sold under normal business practice.

The tax return for the year in which the livestock are replaced should include:

- Date of purchase of replacement stock;
- Cost of the replacement livestock; and
- The number and kind of replacement livestock [IRS Pub. 225, Ch. 13].

### **Replacement of Livestock Due to Environmental Contamination**

If, because of soil or other environmental contamination, it is not feasible to reinvest the proceeds from involuntarily converted livestock into other livestock of a like kind, a taxpayer may invest the proceeds into other tangible or real property used for farming purposes [Sec. 1033(f)].

The Senate Finance Committee Report accompanying the addition of this statute in 1978 indicates that it was intended to assist, among others, farmers who lost their herds due to contamination from polybrominated biphenyl (PBB) [SFC Rept., P.L. 95-600, 1978]. But a communicable bacterial disease which made cattle unsuitable for breeding, known as brucellosis or "Bang's disease," was held not to be an environmental contaminant which allowed the liberal Section 1033(f) reinvestment privilege [PLR 8036014; *M.W. Miller, Jr.*, 615 F Supp 160, 1985].

## **INSTALLMENT SALE CONSIDERATIONS**

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### **Background**

The gain on a disposition of property may qualify for federal tax treatment under the installment method if at least one payment is to be received after the close of the taxable year in which the

sale occurs. The installment method allows the taxpayer to defer the gain on the sale until actual receipt of the cash. The installment method does not apply to sales resulting in losses [Sec. 453(b)].

In an installment sale, the seller finances the buyer's purchase of the property. The installment obligation may be in the form of a contract for deed, deed of trust, note, land contract, mortgage, or other evidence of the buyer's indebtedness to the seller.

Except for depreciation recapture, the seller reports gain on an installment sale only as payments are actually received, with each payment consisting of three parts:

- Interest income;
- Return of investment (basis) in the property sold; and
- Gain on the sale.

The taxpayer has the option of electing out of the installment method by reporting the full amount of the gain in the year of the sale.

Election out of the installment method should be considered where 85% taxability of social security benefits may occur in future years by reporting the installment gain on an annual basis. A time value of money computation needs to be completed on reporting all income in the year of sale vs. deferred reporting of gain under the installment method, where taxability of social security benefits occurs over the installment period due to the annual inclusion of the installment gain.

### **Imputed Interest**

Interest is required to be computed on any sale of property for more than \$3,000, to the extent of any payment due more than six months after the date of sale under a contract under which some of the payments are due more than one year after the date of sale [Sec. 483(c)]. Interest that is provided for in the contract is referred to as stated interest. This interest portion is fully taxable and reported on Schedule B as portfolio income by the seller [Sec. 61(a)(4)].

The minimum interest rate rules do not apply to personal use property [Sec. 1275(b)].

If no interest is stated in the contract, the seller may be required to treat a portion of each payment received as unstated or imputed interest. In general, this occurs if the stated interest in the contract is less than the applicable federal rate (AFR). The unstated interest reduces the stated selling price of the property [Sec. 483(b); Sec. 1274(b)].

**9% Safe-harbor Rate for Smaller Debt Instruments.** If a debt instrument is given in consideration for the sale or exchange of property after June 30, 1985, and if the stated principal amount of the debt does not exceed \$2.8 million, a discount rate of 9% compounded semi-annually may be used in lieu of the AFR rate [Sec. 1274A].

The \$2.8 million debt amount is adjusted annually for inflation:

<u>Year of Sale</u>	<u>Debt Limit</u>
• Through 1989	\$2,800,000
• 1990	2,933,200
• 1991	3,079,600
• 1992	3,234,900
• 1993	3,332,400
• 1994	3,433,500
• 1995	3,523,600
• 1996	3,622,500

[Sec. 1274A(d)(2); Rev. Rul. 97-56, 1997-52 IRB 10.]

The rate equivalents for “9% compounded semi-annually” are as follows:

<u>Compounded</u>	<u>Rate</u>
Annually	9.20%
Semi-annually	9.00%
Quarterly	8.90%
Monthly	8.84%

[Prop. Reg. Sec. 1.483-4(a).]

An aggregation rule applies to treat all sales which are part of the same transaction as one sale and all debt instruments arising from the same transaction as one [Sec. 1274A(d)(1)].

**6% Safe-harbor Rate on Family Land Sales.** In the case of a sale or exchange of land by an individual to a family member, a discount rate of 6% compounded semi-annually may be used in lieu of the AFR minimum, provided the aggregate sales price for all sales between the buyer and seller for the calendar year does not exceed \$500,000 [Sec. 483(e)]. The rate equivalents for “6% compounded semi-annually” are as follows:

<u>Compounded</u>	<u>Rate</u>
Annually	6.09%
Semi-annually	6.00%
Quarterly	5.96%
Monthly	5.93%

[Prop. Reg. Sec. 1.483-4(b)(2).]

The term "land" does not include any structure (whether or not depreciable) or any permanent improvement or cultivation if of a nature subject to cost recovery, amortization, or allowance for depreciation [Prop. Reg. Sec. 1.483-4(b)(2)(iii)(A)].

The members of an individual's family include only the individual's brother and sister, spouse, ancestors and lineal descendants, determined as of the date of sale [Prop. Reg. Sec. 1.483-4(b)(2)(iii)(B)].

*Practice Tips:* The Proposed Regulations state that the safe-harbor 6% rate is only available where the debt instrument is not given in exchange for any property other than land [Prop. Reg. Sec. 1.483-4(b)(2)(i)(B)].

This suggests that a family farm real estate sale should utilize two separate notes or debt instruments where the realty includes nonqualifying depreciable components, assuming there is an intent to use the 6% rate on the land portion of the sale.

Section 483(e)(3) defines the \$500,000 annual limit in terms of "sales price," whereas the Proposed Regulations at 1.483-4(b)(2) define the \$500,000 limit in terms of "stated principal amount of the debt instrument."

The Proposed Regulations include an example permitting a 6% rate on a parent-to-child land sale of \$650,000, where there is a \$250,000 downpayment and a \$400,000 debt instrument.

**Use of IRS Monthly AFR.** Both the minimum interest rate rules of Section 483 and of Section 1274 look to the 100% Applicable Federal Rate or AFR (compounded semi-annually) in determining the possibility of imputed interest on an installment sale. The AFR rates are authorized by Section 1274(d) and published monthly in the Internal Revenue Bulletins.

The AFR which governs an installment sale depends upon the term of the debt instrument:

<u>Term of Debt</u>	<u>AFR</u>
• Not over 3 yrs.	Short-term rate
• Over 3 but not over 9 yrs.	Mid-term rate
• Over 9 yrs.	Long-term rate

In the case of a sale or exchange, the taxpayer may select the lowest AFR in effect for either the month in which there is a binding contract in writing for the sale, or either of the two preceding months [Sec. 1274(d)(2)].

**Applicability of Section 483 vs. Section 1274 Interest Rate Rules to an Installment Sale.** Section 483 applies only to those debt transactions which do not come within the scope of Section 1274 [Sec. 483(d)(1)]. Section 1274 imputed interest is computed under OID (original issue discount) principles, requiring annual accrual adjustment. As such, it is independent of the specific terms of payment or the taxpayer's method of accounting. Conversely, Section 483 imputes interest income and interest expense under the taxpayer's normal method of accounting [Reg. Sec. 1.483-2(a)(1)(ii)].

For cash method taxpayers, any imputed interest income or expense under Section 483 is recognized only when received or when paid.

For accrual method taxpayers, Section 483 imputed interest amounts are taken into account when due.

Section 1274 is the narrower of the provisions, due to a number of exceptions which exempt smaller transactions from Section 1274 and apply the Section 483 rules. Exceptions to Section 1274 include:

- Sale of a farm by an individual, estate, testamentary trust, Section 1244 small business corporation or a partnership meeting Section 1244 requirements, where the sale price does not exceed \$1 million [Sec. 1274(c)(3)(A)].
- Sale by an individual of his or her principal residence [Sec. 1274(c)(3)(B)].
- Sale or exchange of property involving total payments (both debt and other consideration) of \$250,000 or less [Sec. 1274(c)(3)(C)].
- Sale of land to a family member under the 6% safe-harbor rate [Sec. 1274(c)(3)(F)].

Despite the threat of the harsher Section 1274 accrual OID rules to those larger transactions which do not fall within the above exceptions, Section 1274A provides elective relief from OID, allowing imputed interest to be taken into account on the cash method if four criteria are met:

- The stated principal amount does not exceed \$2,000,000 adjusted annually for inflation: [Rev. Rul. 95-10, 1995-1 CB 168; Rev. Rul. 97-56, 1997-52 IRB 10];
  - 1995 \$2,516,900
  - 1996 2,587,500
  - 1997 2,659,900
  - 1998 2,730,800
- The lender does not use the accrual method and is not a dealer with respect to the property sold;
- Section 1274 would otherwise have applied; and
- An election to report the debt instrument under the cash method is jointly made by the lender and borrower [Sec. 1274A(c)(2)].

### Determining Gain Under the Installment Method

The *selling price* is the gross sale price without reducing it by any mortgage on the property. The selling price includes money and any fair market value of property the seller is to receive. The selling price also includes any selling expenses paid for the seller by the buyer.

The *basis* of the property sold must be determined. The taxpayer's original cost or basis in the property is increased by the cost of any permanent improvements and reduced by depreciation taken. Selling costs incurred in the sale are also included in the adjusted basis.

The *gross profit* on the sale is the difference between the selling price and the adjusted basis of the property sold.

The contract price is determined by reducing the selling price by any mortgage or existing debt on the property which is assumed by the buyer. To avoid additional gain recognition, the debt assumed by the buyer cannot exceed the seller's basis in the property. If the debt assumption exceeds the seller's adjusted basis in the property, the excess triggers gain in the year of sale [Reg. Sec. 15A.453-1(b)(3)(i)]. See Example 3-11 on page 77.

#### Example 3-9

George enters into a contract to sell farmland with an adjusted basis of \$55,000 for a sale price of \$120,000. The buyer will assume a mortgage of \$40,000.

The contract price is calculated as:

Selling price	\$120,000
Less mortgage assumed by the buyer	<u>(40,000)</u>
Contract price	<u>\$ 80,000</u>

The *gross profit percentage* is calculated by dividing the gross profit by the contract price. The principal payments collected on the contract are then multiplied by the gross-profit percentage to determine the taxable gain to be reported.

#### Example 3-10

Assume the same facts as in Example 3-9, with the gross profit equal to \$65,000 (\$120,000 sale price less \$55,000 basis). The principal collected in the year of the sale is \$15,000.

The gain is calculated as:

$$\begin{array}{l} \text{Gross profit} = \frac{65,000}{80,000} = 81.25 \text{ gross-profit percentage} \\ \text{Contract price} \end{array}$$

$$\$15,000 \times 81.25\% = \$12,188 \text{ taxable gain}$$

**Example 3-11**

Again, assume the same facts as in Example 3-9, except that George's adjusted basis in the land is only \$35,000.

The \$40,000 mortgage assumption by the buyer exceeds George's basis by \$5,000, causing \$5,000 of gain recognition by George at the point of sale.

George's gross profit percentage is 100%, calculated as follows:

Sale price	\$120,000
Less adjusted basis	(35,000)
Less gain recognized from debt assumption	<u>(5,000)</u>
Gross profit	<u>\$ 80,000</u>

Gross profit of \$80,000 = contract price of \$80,000.

**Depreciation Recapture**

If the property sold in an installment sale is either Section 1245 or Section 1250 property, the sale may be subject to depreciation recapture [Sec. 453(i)].

Section 1245 property is personal property, both tangible and intangible. Single-purpose agricultural structures are considered Section 1245 property.

Section 1250 property is real property. The depreciation taken in excess of the straight line method is subject to depreciation recapture. Real property always depreciated under the straight line method is not subject to depreciation recapture. However, under the capital gain rules effective for payments received after May 7, 1997, the gain on the sale of depreciable real property attributed to straight line depreciation qualifies for a top tax rate of 25%. This new 25% rate often requires recalculation of the components of an old installment sale in order to determine what, if any, portion of the post May 7, 1997, payments qualify for the 25% tax rate.

Depreciation recapture must be reported as ordinary income on Form 4797 in the year of the sale, regardless of the amount of cash collected [Sec. 453(i)].

The amount of depreciation recapture recognized is added to the adjusted basis of the property sold to determine the remaining gain, if any, to be reported under the installment method.



**Example 3-12**

Hiram sells a combine to a neighboring farmer in 1996 for \$45,000, with \$20,000 due July 1, 1996 and \$25,000 due July 1, 1997. Hiram's original cost was \$40,000, and his depreciation on the combine to the point of sale was \$10,000.

Hiram's gain is calculated as follows:

Selling price		\$45,000
Cost	\$40,000	
Less depreciation	<u>(10,000)</u>	
Adjusted basis	30,000	
Add: depreciation recapture	<u>10,000</u>	
Basis for installment sale		<u>40,000</u>
Gain		<u>5,000</u>
Gross profit percentage	$\left(\frac{\$ 5,000}{45,000}\right)$	11.11%
1996 cash received		$\times 20,000$
Gain		<u>\$ 2,222</u>
1996 ordinary gain		\$10,000
1996 capital gain		2,222
1997 capital gain		<u>2,778</u>
Total		<u>\$15,000</u>

*Practice Tip:* Farm real estate sales arranged under installment contracts often result in substantial gain recognition in the year of sale, due to depreciation recapture of Section 1245 assets.

Single purpose livestock facilities, grain storage and drying systems, drainage tile, and irrigation systems are examples of assets often sold as part of farm real estate which produce depreciation recapture.

Because any depreciation recapture is recognized fully in the year of sale, before calculation of the gross-profit percentage, the down payment and any other first year principal payments will cause further gain recognition in the year of sale. It is not possible to consider the cash collections as first applied to the depreciation recapture portion of the income.

A sale of farm realty alone will generally not constitute a transaction subject to Form 8594 (Asset Acquisition Statement) reporting, because real estate, even with improvements, is not a "group of assets which constitute a trade or business" [Reg. Sec. 1.1060-1T(b)].

**Related Party Sales**

A special rule applies if property is sold under an installment sale to a related party who in turn disposes of the property by sale, exchange, gift or cancellation of installment note:

- Within two years of the first disposition; and
- Before making all payments on the first disposition.

Under this rule, the seller of the first disposition must treat the amount the related person receives (or the fair market value if not an outright sale) from the second disposition as if the original seller received it from the first disposition [Sec. 453(e)].

### Example 3-13

In 1997, Charlie sells bare farmland to his son, Junior, for \$100,000, to be paid in 10 equal annual installments, plus interest. Charlie's basis in the land is \$50,000 (gross profit percentage of 50%), and Junior paid Charlie \$10,000 in 1997. In 1998, Junior sells the same parcel, with no improvements, to an outside investor for \$125,000.

Charlie figures his installment sale income in 1998 as follows:

Amount received on 2nd disposition or contract price on 1st disposition, whichever is less	\$100,000
Minus: Prior payments from Junior	<u>(10,000)</u>
Amount treated as payment because of second disposition	90,000
Add payment from Junior in 1998	—
Total payments received and treated as received for 1998	90,000
Gross-profit percentage	<u>× 50%</u>
Installment sale income for 1998	<u>\$ 45,000</u>

Charlie will not report the nine remaining payments of \$10,000 each as income because he has already reported the entire amount in 1997 and 1998.

**Exceptions to the Two-year Related Party Resale Rule.** An involuntary conversion under Section 1033 is not treated as a second disposition. A transfer after either the death of the original seller or of the person acquiring the property in the first disposition is exempt [Sec. 453(e)(6)].

### Installment Sale Dispositions

A gift of an installment obligation is a disposition which results in gain or loss equal to the difference between the basis in the obligation and its fair market value at the time of the gift. A cancellation or sale of an installment obligation also results in gain recognition [Sec. 453B(a)].

**Example 3-14**

George sold bare land with an adjusted basis of \$50,000 in 1994 for \$100,000, resulting in a gross profit percentage of 50%. The outstanding balance of the installment obligation on October 1, 1998 was \$75,000, and on that date, George gave the entire obligation to his son (his son was not the buyer). The obligation had a fair market value on the date of the gift of \$70,000.

George's taxable gain on the disposition is calculated as follows:

FMV of obligation	\$70,000
Basis in obligation	
\$75,000 less 50% G.P.	<u>(37,500)</u>
Gain on disposition	<u>\$ 32,500</u>

George's son receives the obligation at its new adjusted basis of \$70,000, and reports additional income under OID principles to the extent of collections in excess of basis.

**Disposition at Death of Seller.** If a decedent holds an obligation which is being reported under the installment method, the transmission of that installment obligation to an heir of the decedent is not considered a disposition (i.e., the heir continues to report the gain as IRD or income in respect of a decedent) [Sec. 453B(c); Sec. 691(a)(4)]. However, if the installment obligation is bequeathed to the obligor so as to extinguish the debt, the unreported gain is recognized by the estate of the decedent [Sec. 691(a)(5)(iii); Rev. Rul. 86-72, 1986-1 CB 253].

Similarly, if a note due on an installment sale becomes self-canceling at the death of the seller, or is forgiven by the seller, the unreported gain is recognized by the seller [Sec. 453B(f)(1); *Estate of Robert Frane*, 98 TC ¶50,386, CA-8, 7/6/93, aff'g and rev'g TC No. 26]. If the seller and obligor are related persons, the gain recognition which occurs upon cancellation or elimination of an installment receivable must be measured valuing the installment obligation at its face value [Sec. 453B(f)(2)].

**Example 3-15**

Herman is a 70 year old retired farmer who holds an installment receivable from the sale of farmland to his son. The installment obligation has a remaining balance of \$200,000, and a gross-profit ratio of 70%.

Herman's will provides that, in the event of his death, the remaining balance due on the contract is extinguished (i.e., the receivable is a bequest to his son).

If Herman dies currently, his final estate fiduciary income tax return would be required to report the remaining \$140,000 gain. If Federal estate tax was paid on the value of the installment obligation, an offsetting income tax deduction would be allowed under the Section 691(c) IRD (income in respect of a decedent) rules.

*Practice Tip:* Farmers who plan to dispose of highly appreciated farm assets under installment arrangements should be advised that entering into an installment sale creates a certainty that the gross profit on the contract will be recognized, either as they collect the payments during lifetime or by heirs who succeed to the collections. Conversely, if the asset is held without sale until the death of the owner, Section 1014 allows a step-up in basis to fair market value; the heirs will escape the consequences of the income tax attributable to the gain.

**Large Installment Sales.** Interest on deferred tax must be paid to the IRS, based on the amount of deferred tax which has been postponed under the installment method, if the aggregate amount of the taxpayer's installment obligations exceeds \$5 million [Sec. 453A(c)].

To be an installment obligation subject to this rule, the sale price must exceed \$150,000. The face amount of such installment obligations held by the taxpayer which arose during, and are outstanding as of the close of, the taxable year must exceed \$5,000,000 [Sec. 453A(b)(2)].

However, an installment obligation is exempt from this rule if it arose from the disposition of any property used or produced in the business of farming [Sec. 453A(b)(3)(B)].

**Electing Out of the Installment Method.** The installment method automatically applies to all eligible installment sales, unless the taxpayer elects out of the installment method.

The election must be made on or before the due date (including extensions) for filing the seller's income tax return for the year in which the sale occurs [Sec. 453(d)(2)]. The election is made by reporting the entire gain on the seller's return for the year of the sale.

The interest income collected each year must continue to be reported when collected.

### **Reporting an Installment Sale**

An installment sale is reported on Form 6252. The gain is then carried to Form 4797 and/or Schedule D, depending upon the mix of ordinary depreciation recapture, Section 1231 and capital gain.

See Chapter 6 for a further discussion of issues related to transfer of the farm business.

## **INSTALLMENT SALES OF COMMODITIES**

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### **Background**

Farmers and ranchers, as cash-method taxpayers, have traditionally sold their raised commodities (grain, livestock raised for resale, etc.) under various deferred payment arrangements. Some of these arrangements have involved substantial contingencies, such as price-later contracts, under which the commodity is delivered but the sale price remains open until set by the seller.

Other arrangements have included a closing of all events other than a transfer of payment from seller to the buyer, with the actual payment simply scheduled for a later date, generally after the close of a tax year.

Constructive receipt was avoided based on judicial decisions and rulings which held that a binding contract for a sale of grain with payment to be made in the following year would defer the tax reporting of the transaction into the following year [Rev. Rul. 58-162, 1958-1 CB 234; Rev. Rul. 73-210, 1973-1 CB 211; Amend, 13 TC 178; *Sheldon*, 62 TC 96].

The IRS continually attacked deferred payment arrangements. In a 1980 private ruling, the IRS held that a deferred payment contract which could be assigned or transferred had a fair market value and therefore was taxable in the year of sale. Only nonassignable and nontransferable deferred payment contracts would avoid current taxation under the doctrine of constructive receipt [PLR 8001001].

Deferred payment livestock contracts were particularly attacked by the IRS, with the IRS taking the position that the purchaser/dealer was the agent of the farmer/seller, and accordingly constructive receipt by the farmer occurred upon disposition of the cattle by the dealer to the stockyard.

### **1980 Installment Sales Revision Act**

The Code allows farmers to use the installment method of reporting when disposing of property used or produced in the business of farming [Sec. 453(1)(2)(A)].

In the Committee Report to the Installment Sales Revision Act, Congress stated that "Gain from the sale of property which is not required to be inventoried by a farmer under his method of accounting will be eligible for installment method reporting as a gain from a casual sale of personal property even though such property is held for sale by the farmer. The Committee also intends that deferred payment sales to farmer cooperatives are to be eligible for installment reporting as under present law" [Comm. Rpt., P.L. 96-471].

However, the protection afforded to farmers by the 1980 Installment Sales Revision Act seemed to be diluted for alternative minimum tax purposes by 1986 legislation, which states that any disposition after March 1, 1986 of property described in Section 1221(1) was to be reported without regard to the installment method for alternative minimum tax (AMT) purposes [Sec. 56(a)(6)]. It was the IRS's position that Sec. 56(a)(6) meant that farmers who reported sales of property they had produced or grown on the installment method had to compute AMTI without regard to the installment method [e.g., TAM 964003].

However, the 1997 Taxpayer Relief Act retroactively repealed Sec. 56(a)(6) for dispositions in tax years beginning after 1987. Thus, the rule requiring AMTI to be computed without regard to the installment method no longer applies. The 1997 legislation also included a special effective date provision for cash-basis farmers that repealed the AMTI provision for tax years beginning *in* 1987.

*Practice Tip:* Clients affected by this retroactive change should file a refund claim.

### **Corporate Adjusted Current Earnings (ACE)**

Corporations that are still subject to the AMT after the 1997 Taxpayer Relief Act's repeal of the AMT for small corporations (defined in IRC Sec. 55 (e)) are subject to the Adjusted Current Earnings or ACE rules in computing their alternative minimum taxable income [Sec. 56(g)].

Corporate ACE income is to be computed without regard to the installment sale method except for:

- Any disposition under the installment sale method in a taxable year beginning before January 1, 1990; or
- Installment sales in excess of \$5 million on which interest is being paid to the IRS under Section 453A.

This inability to use any installment sale method in calculating corporate ACE income (not merely Section 1221(l) dealer inventory as defined in the Section 56(a) AMT preference) suggests that a cash-method corporate farm will be exposed to ACE and the resulting AMT if it relies on the installment sale privilege to defer commodity sales.

### **Deferred Payment Agreements**

As noted above, the 1980 Installment Sale Revision Act committee report language, granting cash method farmers the safety of the Section 453 installment sale method for commodity sales, was intended to protect farm taxpayers from escalating IRS attacks.

The pre-1980 body of rulings and cases governing “deferred payment contracts” (see above, and Reg. Sec. 1.451-2 re: constructive receipt) continues to be valid today.

Because of the questions regarding possible inclusion of cash-method farm commodity installment sales in corporate ACE income, taxpayers may wish to rely on the deferred payment contract precedents.

Criteria for deferred-payment agreements which avoid constructive receipt include the following:

- A written contract that, under local law, binds both the buyer and the seller.
- Provision in the contract that under no circumstances will the seller be entitled to *any* of the sale proceeds prior to the deferred payment date.
- Execution of the contract *before* the taxpayer has a right to the money, normally prior to delivery.
- Written specification that the taxpayer has no right to transfer or assign the contract rights for cash or other property.
- Prohibition against use of the contract as collateral for any loan.
- The buyer of the commodities may not credit the farmer’s account and then charge the account for sale of seed, fertilizer, or chemicals purchased in the same year.
- The selling farmer’s right to the money is evidenced by a contract, not a note.
- Deferred-payment agreements do not provide interest; this is an attribute of an installment sale.
- The sale is not through an agent of the farmer, since receipt by an agent is considered receipt by the principal.
- Lack of amendment to the contract.
- Price-later contracts should state that in no event can payment be received prior to the desired date, even if a price is established earlier.

[Rev. Rul. 58-162, 1958-1 CB 234; Rev. Rul. 73-210, 1973-1 CB 211; *H. C. Crimmins*, D. N.D., 1980, aff'd. CA-8, 1981, 81-2 USTC 9576; *C. B. Schniers*, 69 TC 511, 1977.]

### **Deferred Payment Sale by Crop Share Landlord**

The IRS has ruled that a cash method crop share landlord was taxable on the sale of grain at the time of entering into a "price later" contract with a grain elevator, rather than upon eventual pricing of the grain and receipt of the cash [TAM 8726007].

The landlord initially stored the grain in the elevator, but then sold the grain and passed title to the elevator, subject to a one-year period during which the taxpayer would select a current market price for payment (a "price later" contract).

The IRS took this position, despite acknowledging the existence of regulations which allow a crop-share landlord to not include crops in rental income until the year they are "reduced to money or the equivalent of money" [Reg. Sec. 1.61-4(a)].

In a subsequent letter dated January 19, 1989 to Senator Charles E. Grassley of Iowa, the Assistant Chief Counsel explained that the IRS position relied on Regulation Section 1.451-2(a), the doctrine of constructive receipt.

Constructive receipt of income does not occur if the taxpayer's control of its receipt is subject to substantial limitations and restrictions. The IRS position was that "such limitations and restrictions do not exist in the price-later contracts."

In a later case, the Tax Court determined that a landlord farmer was entitled to report the sale of grain from crop share rentals to an elevator pursuant to a "price later" contract under the installment method.

Relying on state law, it was concluded that the contract was not payable on demand, called for a determinable price for the grain one year later, and therefore qualified for installment sale treatment.

Under the terms of the contract, the elevator became obligated to pay a determinable price for the grain one year after the contract date, with a right in the farmer to obtain payment at an earlier date [*Applegate v. Comm.*, 92-2 USTC ¶50,623, CA-7, 12/7/92, aff'g 94 TC No. 42].

## **CONSTRUCTIVE RECEIPT OF RENT PAYMENTS AT YEAR-END**

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### **Background**

Generally, under the cash basis of accounting, an item is included in income in the year cash or its equivalent is received [Reg. Sec. 1.446-1(c)(1)(i)]. The doctrine of constructive receipt takes exception to this rule, requiring income to be reported in the year it is constructively received, rather than in the year of actual possession. Situations where constructive receipt applies may cause Form 1099 matching discrepancies with the IRS.

The doctrine of constructive receipt requires that income must be reported in the taxable year that it is:

- Credited to the taxpayer's account;
- Set apart for the taxpayer;
- Made available to the taxpayer so that it can be drawn upon at any time; or
- Made available so that the taxpayer could have drawn upon it if notice had been given by the taxpayer to the payor [Reg. Sec. 1.451-2(a)].

The constructive receipt doctrine may require income reporting prior to the time that payments are received.

Normally, a cash-basis recipient reports income in the year the cash is received. However, a recipient must report income prior to the year the payment is received if:

- The payment is due to the recipient before the end of the year; and
- The recipient could have received the payment before year-end (by physically picking up the payment or requesting that the payment be delivered, not mailed).

#### **Example 3-16**

Joel Ryan rents his farmland to Brian Lee, with rental payments due March 1 and December 31.

On December 31, 1997 Brian issues a check to Joel for the December 31, 1997 rental payment. Both individuals use the cash method of accounting.

In what year does Brian deduct the December 31, 1997 rental payment and in what year does Joel claim the December 31, 1997 rental payment as income?

Brian is allowed to deduct the December 31, 1997 rental payment in 1997 if the check is mailed or delivered to Joel by December 31, 1997. Constructive receipt in 1997 may be implied if Brian offers to deliver the rent check to Joel but Joel suggests the check be mailed so that it is not received until 1998. If the check is mailed and Joel does not receive it until 1998, Joel's rent income is deferred until 1998.

If Brian delivers the check to Joel by December 31, 1997, Joel must report the rent income in 1997, even if the check was delivered after the close of banking hours.

A "substantial restriction" placed on a check may prevent constructive receipt. If a recipient agrees to hold a check received and not cash it until after the first of the year, income is not realized by the recipient until the funds are under his control, free from any restrictions. In addition, the payor will not be allowed a deduction until any restrictions are lifted [*Fischer v. Comm.*, 14 TC No. 792].

Payment made by check may be conditional [Reg. Sec. 1.461-1(a)(1)].

Payment is considered made when a check is mailed or delivered even though not honored by a bank until a later time. Payor (and recipient) should keep proof of date mailed (or received).



A check must be dated in the current year in order to take a deduction. Post-dated checks to the following year require the deduction to be taken in the year the check is dated.

Although case law does not directly address the issue, it can be inferred that an overdrawn account does not prohibit the deduction in the current year if sufficient funds are available when the check is actually presented at the bank [*Field v. Comm.*, 15 TCM 631, 1956].

### **Form 1099 Reporting Requirements Can Cause Matching Problems Under the Constructive Receipt Doctrine**

**Payor Requirements.** Forms 1099-MISC, INT, & DIV must be issued to recipients in the year the payor makes payment.

**Recipient Requirements.** Recipients should claim as income any payments received based on the recipient's method of accounting and the doctrine of constructive receipt.

If the correct reportable income varies from the amount reported on a Form 1099, the recipient should report gross income per the Form 1099 to avoid IRS matching problems. An adjustment should be made on the same tax schedule as the income was reported, to net to the correct amount of reportable income.

#### **Example 3-17**

Bill Smith owes farm rent to his mother, Laura Smith, which is due January 1 of each year. In 1997, Bill made a rent payment of \$10,000 on January 1 for 1997 rent and \$11,000 on December 31 for 1998 rent. Bill mailed the check December 31 to Laura, who lives 1,200 miles away. Bill issued a 1997 Form 1099-MISC to Laura for \$21,000. Laura should report the full amount of rent per the Form 1099-MISC of \$21,000 on Schedule E for 1997. To net to the actual rent Laura received in 1997 of \$10,000, a deduction should be claimed on Schedule E for \$11,000, captioned "Rent received and reported in 1998."

## **PAYMENT OF RENT TO SPOUSE**

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### **Background**

The ever-increasing social security tax serves to motivate taxpayers to deduct expenses which shift income from a proprietor's self-employed business to a form of income which is not subject to payroll tax when received by a spouse. Prior to repeal in 1988, salaries from a proprietor to a spouse were exempt from FICA and frequently served this objective. At this point, only interest and rent payments are generally suitable.

**Interest Expense.** Interest expense paid by one spouse to another on bona fide debt is deductible by the borrower [*S. Shapiro*, 29 BTA 1012, Acq. and *C. Steele*, 38 BTA 589, Acq]. Issues with

the IRS have only centered on whether a valid loan (i.e., debtor-creditor relationship) existed between the spouses.

**Rent Expense: Proprietor to Spouse.** An attorney who reported as a sole proprietor was allowed to deduct as a business expense the rent paid to his spouse for her one-half ownership in the building occupied by his law practice. The building was owned one-half by each spouse, as tenants by entireties. While rental expense for one-half share of the building was deductible, the court noted that no deduction was allowed on the Schedule C of the law practice for the husband's other half share [*D. Sherman and Maxine M. Cox v. Comm.*, 97-2 USTC 50,582, CA-5, 8/5/97, aff'g. TC Memo 1993-326, 7/23/93].

*Observation:* The court rejected an IRS argument that the husband's business expense could only be claimed if the spouses filed separate returns. Joint returns were no barrier to the deduction. The fact that a prior IRS ruling [Rev. Rul. 74-209, 1974-1 CB 46] had approved rent expense between spouses filing separate returns involved an incidental fact which was not determinative to deductibility of the rent by the proprietor.

### Example 3-18

Bill and Barb will be purchasing an additional 80 acres of farmland which Bill, a proprietor, will operate in his farming operation. For 1998, assuming Bill purchases the land, their income is projected as follows

	Bill	Barb	Total
Interest Income	1,000	1,000	2,000
Schedule F	<u>30,000</u>	—	<u>30,000</u>
Adjusted Gross Income	<u>31,000</u>	<u>1,000</u>	<u>32,000</u>
SE Income		30,000	
SE Tax Rate (15.3% × 92.35%)		<u>14.12955%</u>	
Total SE Tax		<u>4,239</u>	

How would their tax return change if Barb purchases the land and rents it to Bill for a net lease amount of \$6,000 annually?

(Text continued on page 88)

**Example 3-18 (con't)**

Bill's SE tax decreases by \$848 to an annual amount of \$3,391, as follows:

	<b>Bill</b>	<b>Barb</b>	<b>Total</b>
Interest Income	1,000	1,000	2,000
Schedule F	24,000	—	24,000
Schedule E	—	<u>6,000</u>	<u>6,000</u>
Adjusted Gross Income	<u>25,000</u>	<u>7,000</u>	<u>32,000</u>
SE Income		24,000	
SE Tax Rate		<u>14.12955%</u>	
Total SE Tax		<u>3,391</u>	

**IRS Rulings on Spousal Rental Arrangements**

For years taxpayers have relied on Revenue Ruling 74-209 to deduct rental payments to their spouses as ordinary trade or business expenses. This Ruling involved a husband and wife, each using the cash method of accounting, who owned Wisconsin real estate as joint tenants. The husband used the property in his business. As payment for the use of his wife's share of the property, the husband paid to her one-half of the fair rental value of the property. The husband and wife reported their income from the property in separate federal income tax returns.

The ruling held that the husband was entitled to deduct as a business expense in his separately filed income tax return the rent he paid to his wife for his use of the Wisconsin real estate owned by them as joint tenants [Rev. Rul. 74-209, 1974-1 CB 46].

The IRS noted that to deny the taxpayer the right to deduct fair rent paid to his wife would, in effect, disregard the wife's right of participation in possession and use of the property. This would conflict with the long standing position of the Service that income from property held in joint tenancy is taxable to the tenants in proportion to their respective interest in the property.

**Jointly Owned Property.** Under Section 162(a)(3), trade or business expenses include rentals used in the trade or business, if it is property in which the taxpayer has not taken title or has no equity interest.

Accordingly, spousal lease arrangements would seem preferable if property is *not* jointly owned (i.e., where a spouse either has complete title, or an individual ownership such as tenancy in common).

There are valid reasons, besides tax avoidance, for separately owned property including:

- Estate planning;
- Creditor protection;
- Spousal inheritance; and
- The property was purchased with one spouse's own resources or before marriage.

**Separate Income Tax Returns.** Revenue Ruling 74-209 involved a situation where married taxpayers filed separate income tax returns. The Revenue Ruling does not specifically state that the filing of separate income tax returns was a determinative factor nor does it state what its position would have been had a joint return been filed; it only cites the separate filing as a fact. This same situation occurred in a 1948 decision allowing rent expense as a deduction when paid from husband to wife [*J.H. Anderson*, 7 TCM 811].

The Tax Court decision in *Cox* solved both the issue of joint vs. separate returns and the issue of jointly held property.

**Bona Fide Landlord-Tenant Relationship Between Spouses.** A farm proprietor was disallowed a deduction for rent paid to his wife for use of her share of jointly owned farmland. The proprietor deducted the rent on his Schedule F, and the spouse reported the rent income on a Schedule E in her name; however, the proprietor deducted all mortgage interest expense and all real estate taxes on his proprietorship schedule.

The IRS national office ruled that the inconsistencies in this arrangement indicated the lack of an arms-length landlord-tenant relationship, and denied the rental deduction [TAM 9206008].

*Practice Tip:* The following factors would assist in establishing the landlord-tenant relationship between spouses, to allow the claiming of rent expense by the farm proprietor:

- Title to the real estate in the name of the landlord-spouse;
- A written lease agreement;
- Rental payments which are reasonable in amount and actually paid annually, with control of the funds remaining with the landlord-spouse;
- Payment of principal and interest on real estate debt should be the responsibility of the landlord, with the interest deducted on Schedule E;
- Real estate taxes also should be paid and deducted by the landlord (unless the lease terms provide a “net lease” arrangement);
- A Form 1099-MISC should be issued by the tenant-spouse to the landlord-spouse;
- Establishment of a separate rental checking account; and
- Use of spousal rental arrangements in community property states should be avoided.

## **SELF-EMPLOYMENT TAX AND FARM RENTAL INCOME**

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Recently, the IRS has been raising an attack on farm rental income, asserting that self-employed social security tax (SE tax) applies when the land is leased to an entity in which the landlord is also involved as an employee or partner. For example, if an individual owns farmland and leases it to a corporation in which the landlord is also an employee, the IRS may assert that the individual's participation in the farming activity as an employee taints the rental income, so as to convert it to SE income.

There are two recent developments where the IRS has raised this position. In *Mizell v. Comm.*, TC Memo 1995-571, the Tax Court imposed SE tax on a landlord who leased farmland to a family farming partnership, in which he was also a materially participating partner. Similarly, in TAM 9637004, the IRS National Office privately ruled that a husband and wife who leased land to their agricultural corporation were subject to SE tax on the cash rental income, because both husband and wife were employees of the corporation.

*Practice Tip:* Farmers who have lease arrangements to an entity in which they also personally participate as an employee or partner should be advised to have a written lease which clarifies that they are not participating in the lease arrangement as landlord by rendering any service or management or consulting advice to the operating entity. To further insulate a farm landlord from this attack, practitioners might consider additional strategies such as transferring title to the leased farmland to a spouse of the owner, where the spouse is not involved in rendering services to the family farming entity. Another strategy might involve transferring the land into a family limited partnership, which in turn leases the land to the farming entity.

## COMMODITY FUTURES TRANSACTIONS

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### Background

The tax reporting categorization of commodity futures contracts continues to be a controversial matter between the IRS and farm taxpayers.

Commodity futures contracts which are used by farmers to hedge against price fluctuations of their farm inventory represent an ordinary income or loss item, and, upon closing of the transaction, are reported on Schedule F.

Farmers may also enter into commodity futures contracts with the intention of making a profit on the transaction itself. This type of transaction is considered a speculative contract, and results in Schedule D capital gain or loss. By special statute, such speculative contracts are deemed to be partially short-term and partially long-term capital gain or loss transactions, with the further requirement that the position in any open transactions be recognized as of the tax year end [Sec. 1256(a)].

### Hedging Transactions

While hedging losses are fully deductible on the Schedule F in the year incurred, speculative losses can only offset capital gains, with any excess deductible up to \$3,000 per year.

Because hedging losses are deductible on the Schedule F, they also reduce self-employment tax, while speculative losses deducted on Schedule D do not.

The IRS issued new regulations in 1993 with respect to hedging transactions [Reg. 1.1221-2T]. The temporary regulations were replaced by final regulations issued in July 1994 [T.D. 8554, 7/13/94, Reg. Sec. 1.446-4; T.D. 8555, 7/13/94, Reg. Sec. 1.1221-2].

Starting in 1994, a farmer must identify a transaction as a hedging transaction in his books and records by the close of the day on which the transaction occurred. The hedging transaction must be identified with the inventory or commodity being hedged. The identification of the specific risk must be made substantially contemporaneously with entering the hedging transaction, but specifically no more than 35 days after entering into the hedging transaction.

As an example, a short sale must be identified as a price hedge against the specific quantity of the commodity stored on the farm. Failure to properly identify results in classification as speculation upon IRS examination.

Qualification of a regulated futures contract as a hedging transaction generally requires three basic factors to be met:

- The futures or option contract must be in the commodities which are produced by the farmer, and within the farmer's range of production;
- The commodity contract must be opposite the farmer's physical position of farm commodities on hand, so as to constitute a price hedge; and
- The farmer must clearly identify the commodity contract as a hedging transaction in his or her records before the close of the day of entering into the contract [IRS Pub. 225, Ch. 5; Sec. 1256(e)(2)].

#### Example 3-19

During July, at a time when he anticipates his current corn crop to yield 50,000 bushels, Cecil becomes concerned about a possible decline in the market price of corn by harvest time. Viewing the current July price for December corn futures as satisfactory, Cecil sells 10 December futures contracts of 5,000 bushels each at \$3.75, to hedge against a possible price drop in his corn crop.

In November, Cecil markets 50,000 bushels of corn for \$4.00 per bushel, and also closes out his futures position by purchasing 10 December corn contracts at \$4.00 per bushel.

Cecil paid commissions of \$700 for the sale and purchase of the December corn contracts.

The futures transaction is a hedge, because Cecil was dealing in a commodity he produced, was within his range of production, and took a futures position opposite of his physical crop. Cecil incurred a hedging loss which is deductible on his Schedule F, computed as follows:

July 1, 1998—sold December corn futures (10 × 5,000 bu. @ \$3.75)	\$187,500
November 15, 1998—bought December corn futures (10 × 5,000 bu. @ \$4.00)	(200,000)
Broker's commissions	<u>(700)</u>
Hedging Loss	<u>\$(13,200)</u>

The hedging loss should be reported as a negative figure on Schedule F, Part I, line 10 (other income).

A futures transaction does not need to be in the same amount as the actual physical commodity on hand. A farmer may cover the physical commodity entirely, or only to the extent price protection is desired [*Stewart Silk Corporation*, 9 TC 174].

However, futures contracts in an amount larger than actual production suggests that the transaction is an investment rather than a hedge [*Wool Distributing Corporation*, 34 TC 323].

### **Speculative Transactions**

A futures transaction involving commodities which are not produced by the farmer, or entered into with the intent of making a profit rather than providing a price hedge to existing inventories, is considered a speculative transaction.

Speculative gains or losses are capital in nature. Capital losses in excess of capital gains are limited to \$3,000 per year as an offset against ordinary income for individual taxpayers. As capital loss transactions, speculative losses do not provide any offset against self-employed ordinary income of farm proprietors or partners. In the case of corporate taxpayers, speculative losses may only offset capital gains, and are limited to a three-year carryback and five-year carryforward.

*Practice Tip:* As a marketing strategy, farmers are often advised to sell their physical production shortly after harvest and replace their position with a futures contract (for business reasons such as eliminating the spoilage risks of storage, eliminating the rental costs associated with physical storage, and providing a more immediate mechanism for selling); however, despite the merits of business reasons for these transactions, both the IRS and the courts do not recognize these futures contracts as a hedge, because the farmer has purchased the contract with the intent of making a profit, rather than as a price hedge offset to a physically owned commodity.

### **Reporting of Speculative Transactions**

Speculative contracts are reported under a "market to market" approach, which treats the contract as sold for fair market value on the last business day of the tax year [Sec. 1256(a)(1)]. Speculative contracts must be reported on Form 6781, Gains and Losses from Section 1256 Contracts and Straddles. The capital gain or loss is treated under the statute as 40% short term and 60% long term [Sec. 1256(a)(3)]. IRS Form 6781 and related instructions are reproduced following this chapter, as Exhibit 3-3.

### **Hedging vs. Speculation**

A cotton futures trader deducted losses attributable to commodity transactions as an ordinary loss, deeming the investments to be "hedges." The court found that because the trader had no inventory, a proper hedge did not exist, and the loss was in fact a speculative loss, giving rise to a capital loss instead of an ordinary loss. Because of the restrictions on deductibility of capital losses, only \$3,000 per year was allowed as a deduction by the trader [*James D. Fortner v. Comm.*, TC Memo 1993-195, 5/4/93].

EXHIBIT 3-1

Form 6198

At-Risk Limitations

OMB No. 1545-0712

1997

Department of the Treasury Internal Revenue Service

Attach to your tax return. See separate instructions.

Attachment Sequence No. 31

Name(s) shown on return

Identifying number

Description of activity (See Specific Instructions on page 2.)

Part I Current Year Profit (Loss) From the Activity, Including Prior Year Nondeductible Amounts. See instructions. (Enter losses in parentheses.)

Table with 5 rows and 3 columns. Row 1: Ordinary income (loss). Row 2: Gain (loss) from sale or other disposition. Rows 2a-2c: Schedule D, Form 4797, Other form or schedule. Row 3: Other income or gains from Schedule K-1. Row 4: Other deductions or losses. Row 5: Current year profit (loss).

Part II Simplified Computation of Amount At Risk (See instructions on page 3 for who may use this part.)

Table with 10 rows and 3 columns. Row 6: Adjusted basis. Row 7: Increases for the tax year. Row 8: Add lines 6 and 7. Row 9: Decreases for the tax year. Row 10: Amount at risk. Includes sub-rows 10a and 10b.

Part III Detailed Computation of Amount At Risk (If you completed Part III of Form 6198 for 1996, see instructions for Part III for 1997 on page 3.)

Table with 19 rows and 3 columns. Rows 11-14: Investment and adjustments at effective date. Rows 15-17: Amount at risk for 1996. Rows 18-19: Amount at risk for current year. Includes sub-rows for effective date and 1996 tax year.

Part IV Deductible Loss

Table with 2 rows and 3 columns. Row 20: Amount at risk from line 10b or 19b. Row 21: Deductible loss. Includes detailed instructions for passive activity losses.





**EXHIBIT 3-2****SAMPLE INVOLUNTARY CONVERSION ELECTION**Description of property lost: CombineReason for loss: FireDate of loss: October 14, 1998Date of (expected) replacement: November 30, 1998

Amount received for involuntary conversion	\$35,000
Less basis or cost of property involuntarily converted	<u>(25,000)</u>
Amount of gain realized	<u>\$10,000</u>
Amount received for involuntary conversion	\$35,000
Less cost of replacement property	<u>(50,000)</u>
Amount of gain recognized (not to exceed gain realized)	<u>\$ —</u>
Cost of replacement property	\$50,000
Less gain deferred (gain realized minus gain recognized)	<u>(10,000)</u>
Adjusted basis of replacement property	<u>\$40,000</u>

**Election**

Pursuant to Section 1033(a)(2)(c), the taxpayer elects to defer gain realized from an involuntary conversion, as disclosed above.

**EXHIBIT 3-3**

Form **6781**

**Gains and Losses From Section 1256 Contracts and Straddles**

OMB No. 1545-0644

**1997**

Attachment Sequence No. **82**

Department of the Treasury  
Internal Revenue Service

▶ Attach to your tax return.

Name(s) shown on tax return

Identifying number

Check applicable box(es) (see instructions):  
**A**  Mixed straddle election  
**B**  Straddle-by-straddle identification election  
**C**  Mixed straddle account election  
**D**  Net section 1256 contracts loss election

**Part I Section 1256 Contracts Marked to Market**

(a) Identification of account	(b) GAIN or (LOSS) For ENTIRE YEAR	(c) GAIN or (LOSS) from column (b) BEFORE 5/7/97
<b>1</b>		
<b>2</b> Net gain or (loss). Combine amounts on line 1 in columns (b) and (c) . . . . .		
<b>3</b> Form 1099-B adjustments. See instructions and attach schedule . . . . .		
<b>4</b> Combine lines 2 and 3, column (b) . . . . .		
<b>5</b> Combine lines 2 and 3, column (c) . . . . .		
<b>Note:</b> If line 4 shows a net gain, skip line 6 and enter the line 4 and 5 amounts on line 7. Partnerships and S corporations, see instructions.		
<b>6</b> If you have a net section 1256 contracts loss and checked box D, enter the amount to be carried back. Do not enter in column (c) more than any loss on line 5 . . . . .		
<b>7</b> Subtract line 6, column (b) from line 4, and line 6, column (c) from line 5. . . . .		
<b>8</b> Short-term capital gain or (loss). Multiply line 7, column (b) by 40%. Enter here and on Schedule D. See instructions. . . . .		
<b>9</b> Long-term capital gain or (loss). Multiply line 7, columns (b) and (c) by 60%. Enter here and on Schedule D. See instructions . . . . .		

**Part II Gains and Losses From Straddles. Attach a separate schedule listing each straddle and its components.**

**Section A—Losses From Straddles**

(a) Description of property	(b) Date entered into or acquired	(c) Date closed out or sold	(d) Gross sales price	(e) Cost or other basis plus expense of sale	(f) LOSS. If column (a) is more than (d), enter difference. Otherwise, enter -0-	(g) Unrecognized gain on offsetting positions	(h) RECOGNIZED LOSS For ENTIRE YEAR. If column (f) is more than (g), enter difference. Otherwise, enter -0-	(i) 28% RATE LOSS
<b>10</b>								
<b>11a</b> Enter short-term portion of line 10, column (h), losses here and on Schedule D. See instructions . . . . .								( )
<b>b</b> Enter long-term portion of line 10, column (h), losses here and on Schedule D. See instructions . . . . .								( )

**Section B—Gains From Straddles**

(a) Description of property	(b) Date entered into or acquired	(c) Date closed out or sold	(d) Gross sales price	(e) Cost or other basis plus expense of sale	(f) GAIN For ENTIRE YEAR. If column (d) is more than (e), enter difference. Otherwise, enter -0-	(g) 28% RATE GAIN
<b>12</b>						
<b>13a</b> Enter short-term portion of line 12, column (f), gains here and on Schedule D. See instructions . . . . .						
<b>b</b> Enter long-term portion of line 12, column (f), gains here and on Schedule D. See instructions . . . . .						

**Part III Unrecognized Gains From Positions Held on Last Day of Tax Year. Memo Entry Only—See instructions.**

(a) Description of property	(b) Date acquired	(c) Fair market value on last business day of tax year	(d) Cost or other basis as adjusted	(e) UNRECOGNIZED GAIN. If column (c) is more than (d), enter difference. Otherwise, enter -0-
<b>14</b>				

## Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

### Change To Note

**Maximum Capital Gains Tax Rates.** For individuals, estates, and trusts, the Taxpayer Relief Act of 1997 generally reduced the tax rates that apply to net capital gain for transactions after May 6, 1997. New columns have been added to Form 6781 to provide for reporting of capital gain and loss amounts from Form 6781 to Schedule D (Form 1040 or Form 1041). See the Instructions for Schedule D (Form 1040 or Form 1041) for other details.

**New columns in Part I.** Columns for **GAIN or (LOSS) For ENTIRE YEAR and GAIN or (LOSS) from column (b) BEFORE 5/7/97** were added to Part I. Report any gain or loss from section 1256 contracts closed out before May 7, 1997, in new column (c).

**New columns in Part II.** A column for **28% RATE LOSS** was added to lines 10 and 11 and a column for **28% RATE GAIN** was added to lines 12 and 13. Report in these new columns all 28% rate transactions. A 28% rate transaction is any gain or loss from a straddle transaction that occurred either:

1. Before May 7, 1997, or
2. After July 28, 1997, for straddles held for more than 1 year but not more than 18 months.

**Purpose of Form.** Use Form 6781 to report:

- Any gain or loss on section 1256 contracts under the marked-to-market rules; and
- Gains and losses under section 1092 from straddle positions.

For more details on section 1256 contracts and straddles, get **Pub. 550, Investment Income and Expenses**.

**Section 1256 contract.** A section 1256 contract is (a) any regulated futures contract, (b) any foreign currency contract, (c) any nonequity option, and (d) any dealer equity option. For definitions of these terms and more details, see section 1256(g) and Pub. 550.

Special rules apply to certain foreign currency contracts. See section 988, and Regulations sections 1.988-1(a)(7) and 1.988-3. If an election is made under section 988(a)(1)(B) or 988(c)(1)(D), attach to your return a list of the contracts covered by the election(s), showing the net gain or loss reported from those contracts, and identifying where the gain or loss is reported on the return. If an election is made under section 988(a)(1)(B), report on Form 6781 the gains and losses from section 1256 contracts that are also section 988 transactions.

Options and commodities dealers must take any gain or loss from the trading of section 1256 contracts into account in figuring net earnings subject to self-employment tax. See section 1402(f).

**Marked-to-market rules.** Under these rules, each section 1256 contract held at year end is treated as if it were sold at fair market value on the last business day of the tax year.

**Straddle.** A straddle means offsetting positions with respect to personal property (all property for terminations after September 4, 1997).

**Offsetting positions.** If there is a substantial decrease in risk of loss to a taxpayer holding a position because that taxpayer or a related party also holds one or more other positions, then those positions are offsetting. Any position that is not part of an identified straddle cannot offset any position that is part of an identified straddle.

**Box A. Mixed straddle election.** Under section 1256(d), you may elect to have the marked-to-market rules not apply to section 1256 contracts that are part of a mixed straddle. A mixed straddle is any straddle in which at least one (but not all) of the positions is a section 1256 contract. Each position forming part of the straddle must be clearly identified, on the day the first section 1256 contract forming part of the straddle is acquired, as being part of such straddle. If you make this election, it will apply for all later years and cannot be revoked without IRS consent. If you are making or have previously made this election, check box A and report the section 1256 component in Part II instead of Part I.

**Box B. Straddle-by-straddle identification election.** Make this election according to Temporary Regulations section 1.1092(b)-3T(d) by clearly identifying each position by the earlier of (a) the close of the day the identified mixed straddle is established, or (b) the time the position is disposed of. No straddle-by-straddle identification election may be made for any straddle in which a mixed straddle election was made or if one or more positions are includible in a mixed straddle account. If you are making or have previously made this election, check box B.

If the net gain or loss is attributable to a net non-section 1256 position, then the net gain or loss is treated as a short-term capital gain or loss. Enter it directly on Schedule D and identify the election. If the net gain or loss is attributable to a section 1256 position, enter the gain or loss in Part I of Form 6781 and identify the election.

**Box C. Mixed straddle account election.** Make this election according to Temporary Regulations section 1.1092(b)-4T(f) to establish one or more

mixed straddle accounts for 1998, by the due date (without extensions) of your 1997 tax return. To make this election, check box C and attach to your return the statement required by the regulations. Report the annual account net gain or loss from a mixed straddle account in Part II and identify the election. See Temporary Regulations section 1.1092(b)-4T(c)(4) for limits on the total annual account net gain or loss.

If you did not make the above elections, and you have a loss on the section 1256 component, use Part II to reduce the loss by any unrecognized gain on the non-section 1256 component before making an entry in Part I. You must also reduce the loss from any section 1256 component of a straddle that would be a mixed straddle if the positions had been properly identified as such.

**Box D. Net section 1256 contracts loss election.** If you have a net section 1256 contracts loss for 1997, you may elect to carry it back 3 years. The amount that may be carried back cannot be more than the net section 1256 contracts gain in the year to which the loss is carried. The loss is carried to the earliest year first. See section 1212(c) for definitions of net section 1256 contracts loss and net section 1256 contracts gain. Make the election by checking box D and entering the amount to be carried back on line 6. To carry your loss back, file an amended return, and attach an amended Form 6781 for the applicable year.

### Part I

**Line 1.** Include on line 1 all gains and losses from section 1256 contracts open at the end of your tax year or closed out during the year. If you received a **Form 1099-B, Proceeds From Broker and Barter Exchange Transactions**, or equivalent statement, include on line 1, column (b), the amount from box 9 of each form. Enter in column (c) the gains or losses from before May 7, 1997, as explained in the **Changes To Note** on this page. In column (a), write "Form 1099-B" and the broker's name. List separately each transaction for which you did not receive a Form 1099-B or equivalent statement, or if the Form 1099-B you received is not for your tax year.

**Line 3.** If the Form 1099-B you received includes a straddle or hedging transaction (as defined in section 1256(e)(2)), it may be necessary to make certain adjustments listed below. Attach a schedule listing each of these adjustments and enter the total(s) in line 3, columns (b) and (c). The column (c) amount is based on total adjustments related to transactions before May 7, 1997, as explained in the **Changes To Note** on this page.

• The regulated futures part of a mixed straddle if you made any of the mixed straddle elections.

• The amount of the loss if you did not make any of the mixed straddle elections or the straddle wasn't identified as a mixed straddle and you had a loss on the regulated futures part that was less than the unrecognized gain on the nonregulated futures part. If the unrecognized gain is less than the loss, enter the unrecognized gain. Use Part I for a loss on the disposition of one or more positions that are part of a mixed straddle and that are non-section 1256 positions if the disposition of no non-section 1256 position in the straddle would be a long-term capital gain or loss, and the disposition of one or more section 1256 positions in the straddle would be a capital gain or loss.

• The regulated futures part of a hedging transaction. The gain or loss on a hedging transaction is treated as ordinary income or loss. See Pub. 550 for more details.

**Lines 4 and 5.** Partnerships enter the amount from line 4 on Form 1065, Schedule K, line 7 (any line 5 amount is reported separately). S corporations enter the amount from line 4 on Form 1120S, Schedule K, line 6 (any line 5 amount is reported separately). Lines 6 through 8 in Part I do not apply to partnerships or S corporations and should be left blank.

**Line 8.** Include this amount on Schedule D (Form 1040), line 4; Schedule D (Form 1041), line 2; or enter the amount as a short-term capital gain or (loss) on the Schedule D for your return (and enter "Form 6781, Part I" in column (a) of that Schedule D).

**Line 9.** Include the columns (b) and (c) amounts on Schedule D (Form 1040), line 11, columns (f) and (g); Schedule D (Form 1041), line 7, columns (f) and (g); or only the column (b) amount as a long-term capital gain or (loss) on the Schedule D for your return (and enter "Form 6781, Part I" in column (a) of that Schedule D).

## Part II

Use Section A for losses from positions that are part of a straddle. A loss is allowed only to the extent it exceeds the unrecognized gain on offsetting positions. The part of the loss not allowed is treated as if incurred in the following year and is allowed to the same extent.

Use Section B for gains from positions that are part of a straddle.

Do not include in Part II a disposition of one or more positions that are part of a hedging transaction, a disposition of a loss position included in an identified

straddle, and a disposition of a position that is part of a straddle if all the positions of the straddle are section 1256 contracts.

**Column (a).** Enter the property, delivery date, and indicate whether the property is a long or short position.

**Column (d).** For positions closed out or sold, enter the closing price or sales price.

**Column (e).** For positions closed out or sold, enter the cost or other basis plus commissions paid. Include nondeductible interest and carrying charges allocable to personal property that is part of a straddle. See Pub. 550 for more details.

**Line 10, column (f).** Include in this column any loss not allowed in the prior year to the extent of the unrecognized gain.

**Line 10, column (g).** Enter the unrecognized gain on positions offsetting those in columns (a) through (f). Figure this column by subtracting the cost or other basis of the offsetting position from the settlement price of that position as of the close of the last business day of your 1997 tax year.

**Line 10, column (h) and line 12, column (g).** Enter in these columns the gain or (loss) for 28% rate transactions as explained in the **Changes to Note** on page 3.

**Lines 11 and 13.** Separate recognized gains and losses into short-term and long-term. Attach a separate schedule. For information about the holding period for straddle positions, see Pub. 550 and Temporary Regulations section 1.1092(b)-2T. Attach a separate schedule for (a) section 988 contracts that are part of a mixed straddle and (b) any gain on the disposition or other termination of any position held as part of a conversion transaction (as defined in section 1258(c)). Identify the net gain or loss and report it on Form 4797, line 10.

Include the line 11a amount on Schedule D (Form 1040), line 4; Schedule D (Form 1041), line 2; or as a short-term capital loss on the Schedule D for your return (and enter "Form 6781, Part II" in column (a) of that Schedule D).

Include the line 11b, columns (h) and (i) amounts on Schedule D (Form 1040), line 11, columns (f) and (g); Schedule D (Form 1041), line 7, columns (f) and (g); or only the column (h) amount as a long-term capital loss on the Schedule D for your return (and enter "Form 6781, Part II" in column (a) of that Schedule D).

Include the line 13a amount on Schedule D (Form 1040), line 4; Schedule D (Form 1041), line 2; or as a short-term capital gain on the Schedule

D for your return (and enter "Form 6781, Part II" in column (a) of that Schedule D).

Include the line 13b, columns (f) and (g) amounts on Schedule D (Form 1040), line 11, columns (f) and (g); Schedule D (Form 1041), line 7, columns (f) and (g); or only the column (f) amount as a long-term capital gain on the Schedule D for your return (and enter "Form 6781, Part II" in column (a) of that Schedule D).

## Part III

Complete Part III by listing each position (whether or not part of a straddle) that you held at the end of the tax year (including any position you are treated as holding because it is held by a related party) if the fair market value of the position at such time exceeds your cost or other basis as adjusted.

Do not include positions that are part of an identified straddle or hedging transaction, property that is stock in trade or inventory, and property used in a trade or business subject to depreciation.

Do not complete Part III if you do not have a recognized loss on any position (including regulated futures contracts).

**Paperwork Reduction Act Notice.** We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is: **Recordkeeping**, 12 hr., 12 min.; **Learning about the law or the form**, 2 hr., 33 min.; **Preparing the form**, 3 hr., 47 min.; **Copying, assembling, and sending the form to the IRS**, 16 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. See the instructions for the tax return with which this form is filed.

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## **CHAPTER 4**

### **TRANSFERRING COMMODITIES AND COMPENSATION ISSUES**

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#### **OVERVIEW**

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An understanding of this chapter will enable you to:

- Evaluate the tax consequences of gifts of commodities and making charitable contributions of farm commodities;
- Identify the situations for which payment of compensation with raised commodities would be appropriate;
- Determine the necessary steps to implement a payment in commodity plan; and
- Identify fringe benefits available to farm employees.

#### **INTRODUCTION**

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The use of raised commodities to accomplish various transfers of wealth has become a very beneficial tool for most farmers. Whether commodities are given to family members or to charities or used as a form of compensation, the end result may be decreased income and self-employment taxes for the farmer.

Farmers occupy a virtually unique position within our federal tax system with respect to their inventories. As discussed in Chapter 1, they have the privilege of using the cash method of accounting. Further, to the extent their inventory consists of a raised product (as opposed to items purchased for resale), the inventory will have a zero tax basis. Finally, as opposed to inventories in other industries, these farm commodities are generally readily marketable by a donee or other recipient. These attributes create a unique opportunity for cash-method farm taxpayers.

This chapter will discuss the critical rules which must be followed to effectively decrease taxes through the transfer of commodities.

#### **GIFTS OF FARM COMMODITIES**

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Cash method farm proprietors might find numerous situations where giving farm commodities to shift income to the donee is advantageous.

- Moving income to minor children of the farmer-taxpayer to take advantage of their low tax rates;

- Assistance with college costs for children of the taxpayer; or
- Support for parents of the taxpayer.

### Tax Consequences to Donor/Farmer

There is no income recognition by a donor upon a gift of inventory [Rev. Rul. 55-138, 1955-1 CB 223 and Rev. Rul. 55-531, 1955-2 CB 520].

While the "assignment of income" doctrine prevents a transfer of income or other accrued earnings from one taxpayer to another, the courts, and subsequently the IRS, have ruled that a gift of raised farm commodities represents a transfer of an asset rather than an assignment of income [*Estate of Farrier*, 15 TC 277, 1950; *SoRelle*, 22 TC 459, 1954 and *Romine*, 25 TC 859, 1956].

The nonrecognition to the donor is only advantageous to the cash method farmer.

An accrual method farmer will have tax basis in raised commodities which often approaches market value, so that little income shifting is accomplished.

The cash method operator, conversely, has zero basis in raised inventory.

In addition to the income tax advantage to the donor, the donor also sidesteps the self-employment tax on the commodities which are given to another; excludable gross income is not considered in determining self-employment income [Reg. Sec. 1.1402(a)-2(a)].

It is generally preferable to give commodities raised in a *prior year*. Opening inventory must be reduced for any cost or undeducted expense relating to the inventory which is given to another [Rev. Rul. 55-138 and 55-531, *supra*].

#### Example 4-1

Farmer X, a cash-method wheat producer, makes a \$10,000 gift of raised wheat to his daughter. This gift was made in the year of production, and represents 5% of the current crop.

5% of the farmer's expenses of producing the crop (seed, chemical, fertilizer, fuel, machinery depreciation, etc.) would be nondeductible. These costs would shift as basis in the inventory to the donee, who could then claim the costs when the crop is sold.

Costs deducted on prior returns will apparently not be disturbed, so that the farmer reporting on a calendar year basis would be allowed to deduct the costs of raising the crop in full if the gift of the raised commodity is not made until the following January (i.e. the grain which is the subject of the gift was raised in a year prior to the year of the gift).

The IRS, in Publication 225, takes the same position, holding that costs which apply to gifts of agricultural products may not be deducted as a farm business expense in the year of the gift or

any later year (by implication, costs deducted in a year *prior* to the gift will be undisturbed) [IRS Pub. 225, Ch. 5].

Form 709, U.S. Gift Tax Return, is required if the value of the gift exceeds the \$10,000 annual exclusion per donee.

*Practice Tip* The key to preventing the “assignment of income” problem is to recognize that two distinct steps must be taken:

1. The donor makes a gift of unsold cash-basis inventory using a prior year crop or commodity.
  - The title transfer must be documented, such as through an elevator storage ticket.
2. The donee independently accomplishes a sale of the commodity, recognizing income because of the zero basis in the commodity.

### **Tax Consequences to Donee**

The donor’s basis carries over to the donee. On raised commodities given in the year after harvest, the donee would succeed to the zero basis of the donor [Sec. 1015(a)].

Assuming the transfer is a gift (rather than compensation for services), the income would be classified as “unearned income” in the hands of the donee, and thus not subject to self-employment tax (i.e. presumably, the donee has not materially participated in the production of the commodity). If the donee has materially participated in the production of the crop, the IRS could assert either of the following:

- The transfer was not a gift but was compensation which is taxable in the year of the transfer even if not sold; or
- The arrangement between the donor and donee is that of a partnership subject to self-employment tax on the reclassified income.

Tax practitioners must recognize the possibility of the “kiddie tax” for children under age 14 where unearned income exceeds \$1,400. Up to the \$1,400 threshold, income is taxed as follows:

- First \$700 of unearned income is tax-free; and
- Unearned income of a child from \$700 to \$1,400 is taxed at the child’s rate [Rev. Proc. 97-57, 1997-52 IRB 20].

**Capital Gain Status.** While the raised farm commodity was inventory in the hands of the farmer-donor, the donee will typically not be in the business of farming so as to have inventory status with respect to the commodity.

Section 1221 defines a capital asset as all property, except for specific items such as inventory, items held for resale, and Section 1231 productive assets used in the trade or business. Several cases have held that capital gain recognition occurs if the taxpayer is not actively conducting a trade or business, even though the asset may have been inventory when formerly in the hands of a related party.

Stockholders were allowed capital gain treatment upon the sale of inventory received from a liquidated corporation [*Greenspon*, 229 F2d 947, CA-8, 1956].

Capital gain was recognized by the executors of a proprietor's fur business [*Estate of Ferber*, 22 TC 261, 1954].

A unique court case involved conversion of farm commodities from inventory to capital asset status by the *same taxpayer* [*W.J. and Alice Asmussen v. U.S.*, 85-1 USTC ¶9304, S.D., 1984].

The taxpayer originally sealed a crop and recognized income when the CCC loan amount was approximately equal to current market. The loan was then repaid, but the crop was held for approximately three more years before ultimate sale at a substantially higher price. The court approved long-term capital gain treatment on the difference between the sale price and the tax basis in the crop (tax basis equal to Section 77 CCC loan income recognition amount).

Capital gain designation is important because of the preferential rate available for capital gains. Further, capital gains can be offset by unused capital loss carryovers.

#### Example 4-2

Ed, a farmer, would like to give his son \$9,000 which Junior will use as a down payment to purchase a house. Junior has a capital loss carryover of \$12,000 from a stock loss he had last year. Both are in the 15% tax bracket, and if Dad gives commodities, rather than cash, Jr. would sell immediately.

Following is the computation of the federal tax savings if Dad makes the gift in the form of commodities as opposed to cash.

Dad—

Self-employment tax savings (\$9,000 × 92.35% × 15.3%)	\$1,272
Federal income tax savings (\$9,000 × 15%)	<u>1,350</u>
Total Savings – Dad	<u>2,622</u>

Junior will have a reportable \$9,000 capital gain. This gain will not result in current tax but rather will consume his capital loss carryover. Over the next three years, this capital loss carryover would have saved Junior \$1,350 (\$9,000 × 15%) anyway (if used to offset ordinary income). Other than the deferred timing aspect of Junior's tax saving, the net savings is simply the self-employed social security tax savings of \$1,272.

**Holding Period of Donee.** In general, the holding period of an asset in the hands of a donee refers to the holding period of the donor [Sec. 1223(2)].

The IRS has raised the argument (not decided by Tax Court) that long-term treatment is achieved only when the asset has been held in investment status for the necessary holding period by the donee [*Ridgewood Land Co. v. Comm.*, TC Memo 1972-16, affirmed on another issue, 477 F2d 135, CA-5, 1973].



The holding period can become a critical issue in light of the favorable capital gain rates after the Taxpayer Relief Act of 1997.

### Use of Proceeds by Donee

Reversion of sales proceeds to the donor or retention of “unfettered command” over the funds will cause taxation back to the donor.

- In an early case, the Tax Court held that income was taxable to the parent, despite a purported transfer of farm property to children. Funds were not segregated to the children, but rather were retained by the parent [*Fry*, 4 TC 1045, 1945].
- A parent was held to be taxable on sales from a citrus grove owned by his four children, as the sales proceeds were often retained by the parent and not reported by the children on their respective tax returns, and the parent retained control over the proceeds from the fruit sales [*Lawhon*, 499 F2d 352, CA-5, 1974].
- A farmer was taxed on crops given to children where the sale proceeds were immediately borrowed back from the children by the parents [*Parkhill*, 385 F. Supp. 204, DC Tex., 1974].
- A farmer who made a gift of soybeans to his wife was determined to remain taxable on the income for self-employment tax purposes. The proceeds from the “gift” were deposited in a joint account where the husband maintained control [TAM 9210004].

*Practice Tip:* The farmer in the above situation failed for additional reasons beyond the “use of proceeds” issue. The IRS ruled that the gift of soybeans to the spouse had no economic substance or independent significance beyond tax avoidance. Also, warehouse receipts were used to transfer title to the soybeans, and the IRS suggested that these were negotiable instruments representing a prior conversion or sale of the soybeans by the farmer. This multi-pronged attack suggests that spousal gifts of zero-basis grain will encounter strong IRS resistance.

In a second opinion regarding the validity of gifts of grain from a self-employed farmer to his spouse, the IRS National Office similarly ruled that the gift lacked economic substance. The IRS held that the gift was a tax avoidance transaction, with no evidence that the donee had actual title to and control of the grain. Again, the proceeds from the sale were deposited in a joint account [TAM 9229002].

To accomplish a valid gift, all of the following elements must occur:

- An intention on the part of competent donor to make a gift;
- Irrevocable delivery by the donor of the property in such a manner so as to vest full title and control in the hands of the donee;
- Acceptance of the gift by the donee; and
- No valuable consideration given back to the donor in exchange for the transfer [*Edson v. Lucas*, 40 F2d 398, CA-8, 1930].

## Dependency Exemption of Child

Assuming that the cash proceeds from the sale of donated commodities are properly segregated in the hands of a child/donee, the specific use of the proceeds for support items could have an adverse impact on the parents' dependency deduction for the child. In general, proceeds in the hands of the child should not be used to provide items of support so as to fail the 50% parental support test, but where parental AGI is high so as to cause Section 151(d) phase-out of personal exemptions, it may be an advantage to move the dependency exemption from the parental return to the child's return.

The requirement of control by the donee after the date of gift raises the question of self-employment income if the gift is in the form of raised livestock.

A donee who assumes the care and feeding of animals after the date of gift would presumably face the risk of Section 1402 material participation and the self-employed social security tax. Several cases have allowed a shift of income to children on gifts of cattle, determined by the degree of control the children displayed over cattle and sales proceeds. Physical segregation of cattle at time of the gift is helpful although not determinative.

Also helpful is a reimbursement from donees of any post-gift maintenance expenses for the animals [*Harold Smith*, TC Memo 1967-229; *Harley Alexander*, 194 F2d 921, CA-5, 1952; *Jones Livestock*, TC Memo 1967-57; *Adolf J. Urbanovsky*, TC Memo 1965-276; and *Shatzer*, 3 TC 914].

## Share Rent Landlord Issues

While raised commodities retain inventory status in the hands of an active farmer, to a share rent landlord raised commodities are the equivalent of accrued rental income.

Raised commodities which are received as rents in a nonmaterial participation lease or passive lease arrangement are considered the equivalent of rental income to the landlord, such that a gift or transfer causes full taxation to the donor under the "assignment of income" doctrine [Rev. Rul. 63-66, 1963-1 CB 13; *Tatem*, 400 F2d 242, CA-5, 1968; Rev. Rul. 75-11, 1975-1 CB 27].

**Practice Tip:** Cash-method farm proprietors and partners who intend to make a gift of raised commodities should be given the following pointers:

- Time the gift early in the year prior to harvest to establish evidence that prior year crop was given;
- Document the gift as a separate transaction preceding the sale of the crop by the donee (i.e. obtain evidence of title of the commodity in the hands of the donee prior to sale);
- Donee must retain full use and control of the sales proceeds; and
- Beware of inventory loans, CCC loans, or other liens against the crop which is the subject of the gift.

## CHARITABLE CONTRIBUTION OF FARM COMMODITIES

Advantages of charitable contributions of farm commodities include:

- Income tax savings if the taxpayers would otherwise be standard deduction filers:
  - The increased standard deduction has eliminated any tax advantage of charitable contributions for many farmers;
  - A charitable contribution of unsold inventory removes the income before recognition, and avoids the need to claim a charitable itemized deduction;

*Practice Tip:* Form 8283 (Noncash charitable contributions) should not be filed, as Form 8283 is only required if the total *deduction* claimed exceeds \$500 (Instructions to Form 8283).

- Self-employment social security taxes will decrease if unsold inventory is donated and Schedule F net income is below the self-employment tax maximums.

For 1998, self-employment income is taxed as follows:

- \$74,066 net Schedule F earnings are subject to the OASDI rate (12.4% rate on \$68,400 base after 50% reduction); and
- All Schedule F net earnings are subject to Medicare rate (2.9%).

### Example 4-3

John Doe, a cash method farmer, normally reports net Schedule F income of about \$65,000 in his joint return. He contributes \$2,000 annually to his church, but his total itemized deductions do not exceed the standard deduction amount. John contributes \$2,000 of unsold grain to his church, rather than selling grain and donating cash.

John reduces his federal income tax by \$560 (28% federal income tax rate  $\times$  \$2,000) and reduces self-employed social security tax by \$283 (15.3%  $\times$  [\$2,000  $\times$  92.35%]), for a total savings of \$843.

*Practice Tip:* A charitable contribution of unsold raised commodities is only effective if it constitutes inventory of an active farm proprietor or partner; a gift of unsold crop-share rents by a farm landlord would trigger taxation to the donor as an assignment of income.

### Mechanical Requirements for a Charitable Gift of Raised Commodities

The taxpayer must be a cash-basis farmer (an accrual-basis farmer receives no benefit from a charitable gift of raised commodities since income is reported as it is earned).

Contribute crop raised in a prior year (If current year's crop is contributed, the costs of raising the crops are not allowed as Schedule F deductions, but rather are deducted as Schedule A contributions).

Segregate the transaction into two steps:

- Gift of the commodity to the charity, with *evidence* that title to the commodity was transferred to the charity; and

- Sale of the commodity by the charity.

The commodity must be zero-basis inventory in the hands of the donor, rather than commodity received as passive share rental income (to prevent assignment of income problem) [Rev. Rul. 75-11, 1975-1 CB 22; *Cullison*, 71-1 USTC 9136, E.D. Ark. 1970; *Parmer*, 468 F2d 705, CA-10, 1972].

### **Use of Charitable Remainder Unitrust**

In a private letter ruling issued December 22, 1993, the IRS National Office ruled that a cash method farmer could make a transfer of unsold commodities to a charitable remainder unitrust without recognition of either gross income or self-employment income [PLR 9413020].

The subsequent sale of the commodities by the trust would not trigger any income or social security taxation, nor would the pre-transfer expenses incurred by the farmer in raising the commodity be adjusted.

The unitrust would provide a lifetime income to the farmer-donor and spouse; at the second death, the principal would spill to the designated charity.

*Practice Tip:* The most crucial step is the transfer of the commodity to the charity.

- The commodity should be delivered to the elevator, with a document such as a storage receipt made out to the charity.
- The receipt should then be given to the charity with a letter from the donor saying the commodity may be sold as it sees fit.
- The buyer/grain elevator should not issue a check to the charity without instruction from the charity.

If these steps are not followed, the IRS will treat this transfer as if the grain were sold by the donor, who then contributed the cash to the charity.

## **PAYMENT OF COMPENSATION IN CASH**

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### **Background**

Cash wages paid by farmers are subject to payroll taxes if the wages paid or the number of employees exceed prescribed limits. Although these limits are higher for agricultural employers than for nonagricultural employers, the penalties for noncompliance are the same for both types of employers.

### **Definition of Agricultural Labor for Payroll Tax Rules**

Generally, agricultural labor includes services performed on a farm. Eligible services include those in connection with raising or harvesting any agricultural or horticultural commodity, including the

raising, shearing, feeding, caring for, training and management of livestock, bees, poultry and fur-bearing animals and wildlife [Sec. 3121(g)(1)].

Maintenance of a farm and its tools and equipment qualifies. Also, processing, freezing, packaging, and delivery duties associated with any agricultural or horticultural commodity constitute agricultural labor, but only if the farm operator produced over one-half of the commodities for which the service is performed [Sec. 3121(g)(4)(A)].

A bookkeeper employed in a farming business is an agricultural employee [Reg. Sec. 31.3121(g)-1(c) (2)].

“Farms” includes stock, dairy, poultry, fruit, fur-bearing animals, and truck farms, plantations, ranches, nurseries, ranges, orchards, greenhouses and other similar structures that are used primarily for the raising of agricultural and horticultural commodities [Sec. 3121(g); Sec. 3306(k)].

**Reporting by Agricultural Employers.** Employers who compensate agricultural laborers file Form 943 to report FICA earnings on an annual basis, as opposed to the quarterly Form 941 submitted by nonagricultural employers. However, payroll deposit rules remain the same.

Circular A, *Agricultural Employer's Tax Guide*, contains instructions for payroll tax compliance by agricultural employers [IRS Pub. 51].

In some instances, an employer may have both agricultural and nonagricultural employees.

- The same employer ID number is used.
- FICA and FWHT deposits must be done using separate bank deposit coupons for each operation; however, the timeliness of the deposit is measured by combining the liabilities.
- Both quarterly Form 941 reports for nonagricultural employment and annual Form 943 for agricultural employment must be filed.
- In determining liability for FUTA, agricultural and nonagricultural employment is tested separately [IRS Pub. 51].

#### **Example 4-4**

Vern Goodman, a sole proprietor, is a hog farmer who employs two full-time employees, with quarterly payroll always less than \$20,000. Vern also operates a small grain trucking business as a sole proprietorship, employing three drivers.

Less than half of the grain hauled by Vern's trucking business is produced in Vern's farming business.

Vern must keep the payroll separate for each operation because he has both agricultural and nonagricultural employees. Vern must make separate FICA and FWHT payroll deposits for the agricultural and nonagricultural payroll. The agricultural labor is not subject to FUTA since Vern has less than 10 agricultural employees and is under \$20,000 of quarterly agricultural wages.

### **Federal Insurance Contribution Act (FICA)**

Cash wages paid to an agricultural employee are subject to FICA if either of the following two tests are met:

- The employer pays an employee cash wages of \$150 or more in a calendar year for farm work; or
- The employer pays cash wages of \$2,500 or more to all farm workers during the year [Sec. 3121(a)(8)(B)].

An exception to the above rules exists if an employer pays a farm worker less than \$150 in annual cash wages. Those wages are not subject to FICA, even if the employer's total cash wages are \$2,500 or more, if the farm worker:

- Is employed in agriculture as a hand harvest laborer;
- Is paid piece rates in an operation that is usually paid on a piece-rate basis in the region of employment;
- Commutes daily from his or her home to the farm; and
- Has been employed in agriculture less than 13 weeks during the preceding calendar year [Sec. 3121(a)(8)(B)].

The amounts paid to these seasonal farm workers do count in the \$2,500-or-more test for determining FICA coverage of other farm workers.

Cash wages paid to a child under age 18 in the employ of a parent are exempt from FICA (for both agricultural and nonagricultural labor) [Sec. 3121(b)(3)(A)].

### **Federal Withholding Tax (FWHT)**

The Omnibus Budget Reconciliation Act of 1989 imposed mandatory FWHT on all cash wages paid to agricultural employees after December 31, 1989 [P.L. 101-239, amending Sec. 3401(a)(2)].

### **Federal Unemployment Tax Act (FUTA)**

Wages paid to agricultural employees are subject to FUTA if either of the following two tests are met:

- The employer paid agricultural cash wages of \$20,000 or more during any calendar quarter in either the current or preceding years; or
- The employer had 10 or more persons (including officers of a family farm corporation) employed for some portion of a day for at least one day during any 20 different weeks in either the current or preceding years.

If either of these two tests are met, the employer is subject to FUTA for a minimum of two years (the current and following year).

*Practice Tip:* Farm corporations, with officer compensation included in total payroll, seem to be particularly vulnerable to the \$20,000-per-quarter test.

When processing farm corporate tax returns, the IRS Centers verify that those entities with annual wages exceeding \$80,000 are filing Form 940, Federal Unemployment Tax Return.

Practitioners should monitor compensation, and identify those entities approaching \$80,000 of annual compensation.

Commodity wages or other noncash compensation items are an option to stay beneath the cash limitation, although this technique is not helpful for the 10 employees test.

Cash wages paid to a child under age 21 in the employ of a parent are exempt from FUTA (for both agricultural and nonagricultural labor) [Sec. 3306(c)(5)].

Different state unemployment systems may have different rules for exempt and non-exempt employees and compensation. Practitioners should be advised to check the rules carefully.

## **PAYMENT OF COMPENSATION WITH RAISED COMMODITIES**

### **Background**

Wages paid to agricultural employees in the form of commodities are not subject to FICA, FWHT or FUTA.

Salaries paid to spouses in commodities reduce Schedule F income and self-employment tax by allocating income away from Schedule F.

In addition, wages paid to a spouse can create “earned income” and qualify the taxpayers for the earned income credit, and important employee fringe benefits.

### **The Statute and Other Authority**

**FICA.** Taxable FICA wages for agricultural labor does not include remuneration paid in any medium other than cash [Sec. 3121(a)(8)(A); Reg. Sec. 31.3121(a)(8)-1(b)].

**FUTA.** Similarly, remuneration for agricultural labor paid in any medium other than cash is exempt from FUTA [Sec. 3306(b)(11)].

### **Treatment of Noncash Wages**

*Noncash* agricultural labor is exempt from federal withholding tax [Sec. 3401(a)(2)].

## Supporting Authority

A South Dakota grain and dairy corporation was not required to withhold or pay FICA on compensation to three employees, where their compensation was defined as 3½% of milk production, 15% of grain production, and one-third of all black calves produced from Holstein heifers bred to Angus bulls [TAM 8252018].

(A copy of TAM 8252018 appears as Exhibit 4–1 at the end of this chapter).

According to the regulations, FICA wages do not include remuneration in any medium other than cash for agricultural labor. This excludes payments made in any other medium, such as lodging, food, clothing, car tokens, transportation passes or tickets, farm products, or other goods or commodities [Reg. Sec. 31.3121(a)(8)-1(f)].

*IRS Publication 225, Farmer's Tax Guide*, contains the following example, clarifying that in-kind compensation received as an employee is not self-employment income:

**If you produce a crop or livestock on land belonging to another and are to receive a specified rate of pay, a fixed sum of money, or a fixed quantity of the crop or livestock, and not a share of the crop or livestock or their proceeds, you may be self-employed or an employee of the landowner. This will depend on whether you are under the direction and control of the landlord.**

***Example.* A share farmer produces a crop on land owned by another person, on a 50–50 crop-share basis. By the terms of their agreement, the share farmer furnishes the labor and half the cost of seed and fertilizer. The landowner furnishes the machinery and equipment used to produce and harvest the crop, and half the cost of seed and fertilizer. A house to live in is provided for the share farmer. The landowner and the share farmer decide how much of the tract should be planted in cotton and how much in other crops. In addition, the landowner is in the hog business and the share farmer agrees to take care of the landowner's hogs in return for ten hogs. The landowner furnishes the feed and other necessities and supervises the care of the hogs.**

**The share farmer is a self-employed farmer for purposes of the agreement to produce the cotton and other crops, and the share farmer's part of the income from the crops is SE income. But, for the services performed in caring for the landowner's hogs, the share farmer is an employee, and the value of the ten hogs received is not SE income. This income is taxable for income tax purposes.**

[IRS Pub. 225, Ch. 15.]



## **IRS Attacks and Related Authority**

**Sham Arrangement.** A 1979 ruling disallowed the FICA exemption for an agricultural employer attempting a sham arrangement.

The employer regularly paid employees with commodity storage receipts equal in value to the amount the employee would otherwise receive in cash. The employer then immediately redeemed the employees' receipts for cash. The ruling concluded that the employer had done nothing more than pay employees with an item immediately converted to cash, and the wages were in economic reality actually paid in cash so as to be subject to FICA [Rev. Rul. 79-207, 1979-2 CB 351].

**Hogs as Commodity Wages.** A hog farm proprietor had an employment agreement which compensated his wife, an employee, in the amount of \$200 cash wages plus 3,000 pounds of live market hogs per month. The employment agreement stated that the employer would deliver the hogs to a market as directed by the employee, and upon delivery at market the title to the hogs would pass to the employee. The hogs were not distinguishable from other hogs taken to market. The IRS National Office ruled that, because the sale of hogs took place almost simultaneously with their delivery to the employee, the economic substance was compensation in cash which was subject to FICA [TAM 9136001].

### **Compensation in Commodities: Transfers of Hogs**

A family farm corporation had a written agreement with its majority shareholder to compensate the shareholder with a cash salary of \$6,000, and with 20% of all butcher hogs at market weight. Additionally, a bonus of up to 20 head of boars weighing no more than 300 pounds could be granted to the husband as president of the corporation.

During 1990, the corporation paid the husband \$6,000 in cash wages and \$34,941 in hogs and boars. The next year, the corporation paid the husband \$11,000 in cash wages and \$41,272 in hogs and boars. Under Section 3121(a)(8)(A), no FICA taxes were withheld or paid with respect to the hogs treated as compensation to the husband.

The IRS ruled that the allocation of the hogs pursuant to the written agreement was equivalent to a payment of cash compensation. The IRS cited Revenue Ruling 79-207 in finding that the substance of the agreement was in fact a cash payment [TAM 9322003]. (A copy of TAM 9322003 is included in this chapter as Exhibit 4-2.)

*Practice Tip:* With the ruling by the IRS National Office in this matter, and the previous ruling in a similar livestock situation in TAM 9136001, the importance of structuring commodity payment techniques using grain is advisable. With grain, a "two step transaction," first with transfer of the commodity to the payee, and a separate and later marketing of the commodity by the employee, can be more readily accomplished. Livestock transfers by an employer, on the other hand, bring the inability to vest control of the commodity with the employee prior to sale.

The IRS District Director for Indiana has issued a newsletter indicating that the IRS will challenge the FICA exemption for noncash wages [*Indianapolis District Director's Newsletter*, Vol. 3, FY 92, March, 1992].

This newsletter states that the IRS interprets the FICA exemption to only apply to *nominal* non-cash payments, and that title and risk of loss are irrelevant in determining whether in-kind payments are the equivalent of cash. However, the Congressional committee reports accompanying the 1950 Social Security amendments (which brought agricultural labor under FICA and added the exemption for noncash payments) contain no indication of an intent to limit the exemption to nominal transfers [House Rpts. No. 1300 and No. 2771, Senate Rpt. No. 1669, 1950-2 CB].

### **Compensation in Commodities: National Office Actions**

As a result of the request of the AICPA Washington office, a memorandum was issued from the IRS National Office to its regional offices, confirming that a legitimate exception exists within the Internal Revenue Code from FICA for agricultural employee compensation paid in commodities.

In a memorandum dated April 5, 1993, the Deputy Assistant Commissioner (Examination Division) stated to the Regional Examination Commissioners that: "Situations in which the economic substance of the transaction was not to compensate the employee in cash should not be challenged, e.g., where in-kind payments of agricultural commodities were made to bona fide agricultural employees and the facts and circumstances demonstrate that the payment/transfer was in-kind, and the recipient employee bore the costs to maintain, was at risk of loss, and did not, in effect, receive a proximate cash conversion" should not be challenged [IRS Memorandum of April 5, 1993 to Assistant Regional Commissioners/Examination from Deputy Assistant Commissioner/Examination].

In response to a large number of IRS examinations initiated in two states (Indiana and Iowa) during 1992 and 1993, and the resulting congressional pressure applied to the IRS to provide clarification in the law regarding Section 3121(a)(8)(A), the IRS Office of Employment Tax Administration and Compliance initiated a project to issue guidance.

A task force, consisting largely of IRS personnel but with several members from academia and public practice, initially met in March 1994 to begin drafting guidelines. This task force had as its objective to provide a set of guidelines, to be issued by the fall of 1994, which identify the principles which govern the application of Section 3121(a)(8)(A). The guidelines emphasize the need for the recipient-employee to exercise full dominion and control over the transferred commodity between the transfer of the commodity as a wage payment and the later disposition or use by the employee, and also to contain examples of when transfers both meet and fail the statutory exemption. The full guidelines are included as Exhibit 4-10.

### **1994 Grain Compensation Ruling**

A farm corporation compensated its two shareholders partially in cash and partially in grain. The grain was properly valued at the time of transfer, reported in the Form W-2 to the employee, and held by the employee for periods ranging from 6 to 10 weeks before sale.

The IRS National Office ruled that these transfers were subject to FICA for the following reasons:

- The arrangement lacked a business purpose; a noncash medium of compensation was used primarily to avoid payroll taxes.

- The employees did not bear the costs of ownership because the employer provided free storage in its grain bins after transfer and before sale.
- The employee grain was commingled with employer grain, and thus lacked identification.
- The interest at the time of transfer was to convert the grain into cash [TAM 9403001].

(A copy of TAM 9403001 is reproduced in this chapter as Exhibit 4–3.)

*Observation:* The fact that the employees did not bear the costs of storage from date of transfer to date of sale represents a weakness in the taxpayer's position in this case. However, the attempt by the National Office to input a "business purpose" or "intent" to test this statute seems to lack authority. Also, the National Office assertion that commingled grain prevents identification of the transferred commodity represents an argument which ignores the commercial practices on virtually every commodity transfer in the marketplace; this argument is also inconsistent with TAM 8252018.

### **Other Issues and Authorities Related to Family Employment**

Occasionally, IRS agents will attack family compensation on the merits of the ability to employ family members.

A 1973 Revenue Ruling discusses the ability of a parent to pay reasonable wages to a minor child [Rev. Rul. 73-393, 1973-2 CB 33].

A 1984 private letter ruling supports an optometrist/proprietor's ability to employ his spouse as a receptionist and bookkeeper, clarifying that the payments to her as an employee are not self-employment income [PLR 8452053].

IRS agents have also on occasion attempted to disallow spousal compensation on the premise that the spouse was a partner rather than employee.

A 1982 ruling holds that, whether in a community property or noncommunity property state, the spouse who exercises substantially all of the management and control of the business will be considered the proprietor [Rev. Rul. 82-39, 1982-1 CB 119].

A farm proprietor/landlord was allowed a salary deduction for payments to his spouse/employee, despite an IRS agent's assertion of the existence of a partnership and the lack of a rental payment for land owned by the spouse [TAM 8742007].

(A copy of TAM 8742007 appears as Exhibit 4–4 at the end of this chapter.)

*Practice Tip:* The establishment of formalities such as a written employment agreement and issuance of a W-2 wage statement will provide a substantial defense against IRS assertions that a spouse was a partner rather than the employee of a farm proprietor. Also, to the extent a spouse holds title to real estate which is farmed by the other spouse, rent should be paid by the proprietor to the landlord spouse (reference page 89).

Possible situations for payment of salaries in commodities include those situations where FICA coverage is of minimal benefit.

- Salaries from a family corporation to children and spouse of the primary shareholder;
- Salaries to spouses;
- Salaries to children of a farm proprietor after the children have attained age 18 [Sec. 3121(b)(3)(A) exemption no longer available]; and
- Salaries to corporate shareholders in excess of a base cash salary which brings the desired level of Social Security benefit coverage.

*Practice Tip:* Many practitioners advise their clients who are farm employers to avoid use of commodity wages to nonfamily employees, due to the risk of a later assertion by the employees that their Social Security benefits (whether retirement, disability or survivor benefits) were unduly and improperly reduced by the employer's method of compensation.

### **Implementation Procedures for Payment of Wages in Commodities**

To utilize payment of compensation with raised commodities, the labor must be performed in an agricultural operation. The transfer to the employee and the sale must be two distinct and separate transactions:

- *First:* The employer transfers the commodity to the employee in payment for services. This establishes the value of the compensation for Form W-2 reporting. Documentation of title to the commodity should be obtained on the date of transfer to the employee. Examples of such evidence would include a grain scale ticket, or elevator storage receipt, or delivery receipt in the employee's name.
- *Second:* The employee sells the commodity under the employee's sole direction and control. This second step should be separated by time from the employer's transfer, to strengthen the evidence that the employee had control of the commodity prior to sale. Because some commodities, such as livestock and dairy products, do not lend themselves to a time lag between employer transfer and employee sale, it is preferable to use grain for commodity wages where possible.

Per the newly issued commodity guidelines, the employee needs to pay any costs associated with storage, feeding and shipping of the commodity after taking possession. These costs are then deductible as Miscellaneous Itemized Deductions on the employee's Schedule A.

The amount of compensation to the employee must be reasonable in relation to the services rendered [Sec. 162(a)(1)].

### **Recommendations for Documentation of Payments in Commodities**

All employees paid in commodities should be covered by an employment contract. The employment contract should:

- Specify *employee* status;

- Define quantity or percentage of commodity to be transferred as compensation;
- State that the employee has complete control and risk of loss with respect to marketing/sale of the commodity after transfer of the commodity from employer;
- State that the employee provides labor only; all farm expenses should continue to be the responsibility of employer (if not, there is a risk of self-employed or partner status for employee); and
- Recite any fringe benefits which are also being provided to the employee.

**Reporting Requirements.** Employers are required to issue a Form W-2 wage statement to employees whether paid in cash or commodities under Section 6051(a). Failure to file Form W-2 subjects the employer to penalties under Sections 6721 and 6722.

The amount of compensation is the market value of the commodity at date of transfer of the commodity from the employer to the employee. This amount normally will differ from the value of the commodity on the date sold. See Exhibit 4-5 for a sample Form W-2.

**Schedule D Reporting by Employee.** In most circumstances, an employee will incur a gain or loss on the commodity wages. The gain or loss is equal to the difference between the selling price of the commodity and the employee's basis (with the basis equal to the value reported as W-2 income to the employee on date of employer transfer). The gain or loss is reported on Schedule D as a short-term or long-term capital transaction, determined by the number of days the commodity was held. See Exhibit 4-6.

**Schedule F Reporting by Employer.** Agricultural employers must report income from the transfer of zero basis appreciated property issued in exchange for services. This should be reported as "Other Income" on Schedule F [TAM 9202003, with reference to Section 1001, and Rev. Rul. 69-181, 1969-1 CB 196]. The employer also claims a corresponding deduction for "labor hired" on Schedule F [Sec. 83(h)]. See Exhibit 4-7.

**Advising Clients.** Required Guidelines for Payment of Wages in Farm Commodities is provided as Exhibit 4-8, to assist the client in understanding the proper procedures for paying agricultural employees in commodities.

A Farm Commodity Payment Worksheet is also provided as Exhibit 4-9, to assist the client in documenting the commodity transferred to the employee.

### **Medical Reimbursement and Health Insurance Plans**

Wages paid to a spouse, under an employment agreement with fringe benefit arrangements, will allow the deduction for family health insurance premiums and out-of-pocket medical expenses on Schedule F as an employee benefit. The benefits of Schedule F deduction for these expenses are substantial:

A full deduction is allowed for health insurance premiums, as opposed to 45% (the deduction is slated to rise to 100% by the year 2007) deductibility on Form 1040, Adjustments to Income, which is allowed to the extent of self-employed income.

As itemized deductions, out-of-pocket medical expenses and health insurance are beneficial only if these expenses are greater than 7.5% of Adjusted Gross Income, and if total itemized deductions are greater than the standard deduction.

Deductibility of these expenses as employee benefits on Schedule F decreases self-employment tax.

*Practice Tip:* For self-employed farmers who are unable to take advantage of spousal employment and the resulting medical fringe benefit arrangements, practitioners might wish to consider recommending the use of Medical Savings Accounts [see IRC Sec. 220]. With MSAs, the individual enrolls in a high-deductible health insurance plan, supplemented by a fully-deductible MSA designed to cover out-of-pocket expenses incurred before reaching the insurance coverage. In some cases, third-party administrators are used to implement medical reimbursement and health insurance plans.

Advantages of using third-party administrators include:

- Ensures all Department of Labor requirements are met;
- Verifies expenses for deductibility;
- Ensures documentation requirements are met (e.g., properly drafted Medical Reimbursement Plan); and
- Imposes discipline on client of meeting requirements to allow deductibility (e.g., employment agreement, separate checking account, etc.).

Disadvantages of using third-party administrators include:

- Additional cost to client; and
- Required consistency within accounting firm (i.e., if third-party administrator is required for some clients, it should be required for *all* clients using medical reimbursement and health insurance plans).

**Example 4-5**

In 1998, Farmer Lee pays his wife a \$12,000 commodity wage and claims a Schedule F employee benefit deduction for the family health insurance (\$3,000) and out-of-pocket medical expenses (\$2,000).

Schedule F net income, prior to the commodity wage and employee benefits, is \$40,000.

<b>Tax Computations</b>	<b>With Wage and Benefits</b>	<b>Without Wage and Benefits</b>
Wage	\$12,000	\$ —
Schedule F	23,000*	40,000
45% health insurance		(1,350)
50% SE tax	(1,625)	(2,825)
Standard Deduction	(7,100)	(7,100)
Exemptions	<u>(5,400)</u>	<u>(5,400)</u>
Taxable Income	<u>\$20,875</u>	<u>\$24,724</u>
Tax	\$ 3,131	\$ 3,499
SE Tax	<u>3,250</u>	<u>5,650</u>
Total Tax	<u>\$ 6,381</u>	<u>\$ 9,149</u>
Total Savings		<u>\$2,768</u>
* Preliminary Schedule F		\$40,000
Wage to spouse		(12,000)
Health insurance		(3,000)
Medical expenses		<u>(2,000)</u>
Net Schedule F		<u>\$23,000</u>

**Discrimination Tests for Employee Medical Benefits**

**Insured Plans.** The 1986 Tax Reform Act added discrimination standards in new Section 89, to require employers to offer medical insurance on a nondiscriminatory basis to employees.

Public Law 101-140 (enacted 11/8/89), repealed the Section 89 discrimination tests, with the repeal retroactive as if included in the Tax Reform Act of 1986.

Because of the reversion to pre 86 TRA standards, there is no discrimination standard applied to health benefits provided by an employer under an insured plan [Sec. 106].

**Medical Reimbursement (Uninsured) Plans.** For health benefits (other than insurance) provided by an employer under a self-insured medical reimbursement plan, the following discrimination standards apply:

- The plan must benefit 70% or more of all employees, or 80% or more of all employees who are eligible to participate in the plan.
- A self-insured health plan is discriminatory if it favors highly-compensated individuals either as to eligibility to participate or as to benefits [Sec. 105(h)].

Employees that may be excluded from participation in the plan include:

- Those who have not completed three years of service;
- Those who are under age 25;
- Nonresident alien employees;
- Employees covered by an agreement between employee representatives and the employer (e.g. union plan); and
- Part-time or seasonal employees (defined as those working customarily less than 35 hours per week or less than nine months per year - where the employer has other employees in similar work performing substantially full-time services, or who are defined as employees whose customary employment is less than 25 hours per week or less than seven months per year - where the employer has no other employees performing substantially the same services in a full-time capacity) [Reg. Sec. 1.105-11(c)].

### **Authority and Compliance Pointers for Medical Fringe Benefits**

A proprietor was allowed to deduct (as a Section 162 business expense) the costs of an accident and health plan covering several bona fide full time employees, one of whom was the spouse of the proprietor. The reimbursed health plan amounts received by the spouse were not includible in income per Section 105 [Rev. Rul. 71-588, 1971-2 CB 91].

A husband operating a consulting business as a sole proprietor was allowed to deduct medical expense reimbursements paid to his wife, a bona fide employee of his business. The reimbursements were pursuant to a written accident and health plan, and covered medical expenses that the wife incurred on behalf of the entire family, including the husband [TAM 9409006].

*Practice Tips:* If the employee is a family member, a written employment agreement should be used, which also specifies and defines the fringe benefits being provided.

The health insurance premiums and medical reimbursements should be paid (or reimbursed with documentation) from the farm business checking account. Full family coverage is permitted, effectively allowing the proprietor or partner's share of medical costs to become a deductible expense. Medical insurance premiums can be provided selectively to certain employees, whereas a medical reimbursement plan must be provided on a nondiscriminatory basis.

## **MEALS AND LODGING FRINGE BENEFIT**

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### **Background**

Employers are permitted to provide tax-free meals and lodging to an employee where it can be established that this fringe benefit is necessary for business reasons of the employer. The farming and ranching sector has been successful, in a long line of judicial interpretations, in establishing business reasons for requiring employees to be housed on the business premises.



Because this is a fringe benefit which can only be provided tax-free to an employee, it is generally considered to be available only to the individual who is an employee of a regular corporation (although limited authority exists for partners who are provided this fringe in their employment capacity).

### **Corporate-Provided Meals and Lodging**

**Statutory Authority.** A corporate deduction for necessary meals and lodging provided to an employee is claimed under Section 162 as an ordinary and necessary business expense.

The key statute is Section 119, allowing the recipient employee to exclude the value of employer-provided meals and lodging from gross income.

**Basic Criteria.** The exclusion applies to the value of meals or lodging furnished to an employee, the spouse of an employee, or any of the employee's dependents. The meals and lodging must be "for the convenience of the employer" and "as a condition of employment" (i.e., an ordinary and necessary business expense of the employer), and the meals and lodging must be furnished on the business premises of the employer [Sec. 119(a)].

**Furnishing of Lodging.** The Tax Court holds that the test of "on the business premises" requires that the lodging constitute an integral part of the business property, or be premises on which the company carries on business activities [*Dole*, 43 TC 687, 1965; affirmed CA-1, 351 F2d 308, 65-2 USTC 9688].

An employer-owned residence located two blocks from a motel which the taxpayer managed for the employer was held not to meet the criteria of "on the business premises" [*C.N. Anderson*, CA-6, 371 F2d 59, 67-1 USTC 9136].

Conversely, a house furnished to a hotel manager across the street from the corporate hotel was considered "on the business premises" and income excludability was permitted [*J.B. Lindeman*, 60 TC 609].

Lodging includes:

- The furnishing of utilities [Rev. Rul. 68-579, 1968-2 CB 61; *Harrison*, TC Memo 1981-211].
- Household furnishings [*Turner*, 68 TC 48, 1977].
- Telephone services [*Hatt*, TC Memo 1969-229].

**Furnishing of Meals.** Meals provided with the furnishing of lodging include:

- Meals furnished on nonworking days if the meals are considered for the convenience of the employer; and
- Meals furnished to spouse and dependents [Reg. Sec. 1.119-1(a)(2)(i)].

Meals provided during work hours only, without furnishing lodging would be deductible in the following situations:

- Emergency call situations requiring on-the-job meals;

- Short meal break for business reasons (e.g. bank teller required to work over busy lunch hour); or
- Insufficient eating facilities in the vicinity of the employer premises requires meals to be furnished by the employer.

But the above situations apply only to meals furnished during work hours, except for restaurant employees furnished a meal before or after their shift [Reg. Sec. 1.119-1(a)(2)].

Does the furnishing of meals encompass the furnishing of groceries? The Ninth Circuit held that groceries purchased by a federal employee stationed on Wake Island could not be deducted as meals furnished by the employer. Section 119 allows an exclusion from income for an employer-provided benefit, not an employee deduction [*M.A. Tougher, Jr.*, CA-9, 441 F2d 1148, 71-1 USTC ¶9398].

Groceries which were prepared into meals and consumed on the business premises were excludible from the employee income. Also, nonfood items such as napkins, toilet tissue and soap were also excludible from gross income as an integral part of meals and lodging [*Walter Jacob*, CA-3, 493 F2d 1294, 74-1 USTC ¶9316].

A farm corporation was allowed to deduct grocery purchases where corporate employees (farm wives) purchased the groceries and converted them to meals which were furnished to the corporate employees on the farm premises [*John M. Harrison*, TC Memo 1981-211].

### **Key Farm and Ranch Cases: Taxpayer Victories**

Wyoming cattle ranch operation [*Wilhelm*, 257 F Supp 16].

California grape and crop farm corporation, where corporate-owned residences were two and six miles from the farm [*Caratan*, initially lost in 52 TC 960, 1969, but reversed by Ninth Circuit, 442 F2d 606, 1971].

Ranch corporation employee required to live on premises 8 months of year, where land was leased for cattle grazing by corporation to his sons [*McDowell*, TC Memo 1974-72].

Kansas grain and dairy farm corporation [*Harrison*, TC Memo 1981-211].

Illinois grain farm corporations [*J. Grant Farms, Inc. and Denny L. Johnson*, TC Memo 1985-174 and TC Memo 1985-175].

- *Grant*: 8 sows and 1 boar; *Johnson*: No livestock. Each corporation operated about 1,000 acres.
- *Court's Justification*: Farming operation requires a manager available 24 hours, in view of grain drying and value of inventory and equipment.

### **Employee vs. Partner**

In general, Section 119 is drafted as an employee fringe benefit statute, and accordingly would appear to only be available to an individual in an employee capacity, as opposed to a partner or proprietor.

However, relying on Section 707(a), which treats a partner dealing with the partner's own partnership in a capacity other than as a partner, the Fifth Circuit has held that the deemed employee status of a partner allows the exclusion of the value of meals and lodging furnished for the convenience of the partnership on the business premises [*Armstrong v. Phinney*, CA-5, 394 F2d 661, 68-1 USTC ¶9355].

Earlier court cases held to the contrary, agreeing with the IRS position that a partner is not allowed to achieve employee status for Section 119 [*E. Doak*, CA-4, 234 F2d 704, 56-2 USTC ¶9708; *T. Robinson*, CA-3, 273 F2d 503, 60-1 USTC ¶9152; *R. Moran*, CA-8, 236 F2d 595, 56-2 USTC ¶9879; *Briggs*, CA-10, 238 F2d 53, 56-2 USTC ¶10,020, and Rev. Rul. 53-80, 1953-1 CB 62].

However, *all* of the preceding cases involved adjustments to pre-1954 years, prior to adoption of Section 707 and the ability under Section 707(c) to treat payments made to a partner for services as made to one who is not a partner. See *Armstrong v. Phinney* for a complete discussion distinguishing these prior cases from deemed-employee status after 1954 adoption of Section 707.

*Practice Tips:* Beware of other employees residing on the premises, so as to eliminate the need for shareholder-employee meals and lodging [*Atlantic Biltmore Hotel*, CA-5, 349 F2d 677, 65-2 USTC ¶9573].

Cash meal allowances received by the employee from the employer are not excludible from income [*Kowalski*, S. Ct., 434 US 77, 77-2 USTC ¶9748].

For closely held corporations, consider the use of written contracts to authorize corporate-provided meals and lodging as a job requirement, and recite the business reasons for requiring 24-hour presence of the employees.

- Require the employee to provide replacement labor for any periods of extended absence.
- Add employees to the corporate payroll with duties expressly to prepare and furnish the corporate meals.

Recognize that a corporate-owned residence will allow a deduction for depreciation.

- A corporate-owned residence eliminates the availability of Section 121 gain exclusion as the property is no longer in personal residence status.
- If the residence is held outside of the corporation, the corporation should have a lease with the individual owner, and pay rent to the individual for the use of the residence for purposes of providing housing to corporate employees.
- Consider retention of the residence in the hands of the individual shareholder until retirement, at which time the residence may be sold to the corporation, allowing tax-free receipt of the sales proceeds from the corporation using Section 121 to shelter the gain in the hands of the individual.

Section 1372 prohibits S corporation employees owning, directly or indirectly, more than 2% of the outstanding stock from receiving the benefits of Section 119 fringe benefits.

## EXHIBIT 4-1

TAM 8252018

Index No. 3121.01-16

8252018

This document may not be  
used or cited in prece-  
dent. Section 6110(J)(3)  
of the Internal Revenue  
Code.  
17 SEP 1982

INTERNAL REVENUE SERVICE

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

District Director  
[REDACTED]Taxpayer's Name:  
Taxpayer's Address:Taxpayer's Identification No.:  
Years Involved:  
Date of Conference:ISSUE

You requested technical advice concerning whether certain noncash payments to three of the taxpayer's workers are wages for purposes of the Federal Insurance Contributions Act (FICA).

FACTS

The taxpayer is a corporation, which is engaged in the business of farming. The primary farming activities are the cultivating, growing, and harvesting of grain and the breeding, raising, and milking of cattle.

The taxpayer employs workers to carry out its farming activities. Most of the workers are employed on a seasonal basis, and they are compensated with cash payments. The taxpayer has entered into separate agreements with three of its workers. These agreements provide that the workers will receive noncash payments for their respective services. The technical advice request memorandum concerns the noncash payments made to these three workers.

The taxpayer considers these three workers to be employees. They are primarily responsible for the management of the farm operation. The agreements provide that these employees are compensated by the taxpayer on the basis of agricultural products produced. These employees are not entitled to cash payments. Two of the employees receive, respectively,  $3\frac{1}{2}$  percent of the milk produced plus one-third of all black calves produced from Holstein heifers which are bred to Angus bulls. The taxpayer provides the feed, veterinary service and other calf production services. The third employee receives a percentage of the grain production. In 1980, the percentage of the crop was changed from 25 percent to 15 percent.

Exh 4-1 *continued*

District Director  
[REDACTED]

8252018

The taxpayer's representative states that when noncash payments are made, the commodities are commingled with other products of the taxpayer. The taxpayer maintains records of pounds of milk and bushels of grain produced. The employees' portion of milk produced is converted to cash once a month although the buyer picks up the milk every other day. When the employee decides to sell his portion of the noncash payment received in the form of grain, he removes his portion of grain from the bin and delivers it to a buyer, usually a cooperative grain elevator. He accounts to the taxpayer for the quantity of grain removed from the bin.


In the case of calves used as noncash payments, the taxpayer and the employees are able to specifically identify the calves belonging to the employees. The risks and benefits, if any, of market price fluctuations, quantity of calf production, and death of the calves are borne by the employees. The employees are not guaranteed a certain number of calves for their services, and if an employee's calf dies, the employee does not receive another calf as a replacement. The employees normally retain the calves for six months to eighteen months before selling.

When the employees decide to convert their noncash payments to cash, they can sell to any buyer they choose. In the case of milk production, the employees have been selling to the same buyer as the taxpayer. The taxpayer is a patron of a milk producers association. The association provides transportation of the milk from the various area farms. Because the milk is highly perishable, the employees find it more convenient to sell the milk to the association than to seek other buyers.

#### LAW

Section 3121(a)(8)(A) of the Internal Revenue Code provides that, for purposes of the taxes imposed by the FICA, the term "wages" does not include remuneration paid in any medium other than cash for agricultural labor.

Section 31.3121(a)(8)-1(b) of the Employment Tax Regulations provides that the term "wages" does not include remuneration in any medium other than cash for agricultural labor. Section 31.3121(a)(8)-1(f) states that cash remuneration includes checks and other monetary media of exchange. Cash remuneration does not include payments made in any other medium, such as lodging, food, clothing, car tokens, transportation passes or tickets, farm products, or other goods or commodities. (Underscoring supplied.)

Exh 4-1 *continued*District Director  


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Rev. Rul. 79-207, 1979-2 C.B. 351 discusses a situation in which a company operates a farm and seeks to avoid the FICA taxes by paying its employees with commodity storage receipts rather than with cash. The value of the storage receipts is equal to the amount that the employees would otherwise receive in cash. The company immediately redeems the employees' receipts for cash. Rev. Rul. 79-207 concludes that the employer has done nothing more than pay its employees their remuneration with an item immediately converted to cash. The payment in commodity storage receipts was, in economic reality, a payment in cash. Accordingly, the cash value of the commodity storage receipts paid to the farm employees is not excepted from wages under section 3121(a)(8) of the Code.

#### RATIONALE

The information furnished shows that the three employees in question agreed to receive farm products for their services instead of cash. The noncash payments were based on a percentage of the farm products that were produced by the services of the employees.

The facts in this case are substantially different from the facts in Rev. Rul. 79-207. In the Rev. Rul., the employees did not receive farm products. The payments in Rev. Rul. 79-207 are commodity storage receipts, which are equal to the amount the employees would otherwise receive in cash. The receipts were immediately redeemed by the company for cash. In the taxpayer's case, the employees receive farm products, not receipts, and have control over the farm products. The farm products are not redeemed by the taxpayer for cash. The risks and benefits belong to the employees.

We conclude that the employees in question received farm products for their agricultural services for the taxpayer. No evidence was submitted that shows that farm products received were, in fact, a pretense or deceptive attempt to circumvent the law as in Rev. Rul. 79-207.

Section 31.3121(a)(8)-1(f) of the regulations specifically provides that farm products are not cash remuneration. Because the remuneration in question is for agricultural services and is not in cash, it is not wages for purposes of the FICA.

Exh 4-1 *continued*

District Director  
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CONCLUSION

We conclude that the remuneration in question paid by the taxpayer to its three agricultural employees was farm products, not cash payments. Accordingly, the remuneration is not wages and is excepted from the taxes imposed by the FICA.

A copy of this technical advice memorandum is to be given to the taxpayers. Section 6110(j) of the Code provides that it may not be used or cited as precedent.

-END-

**EXHIBIT 4-2**

TAM 9322003

**9322003**

*"This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code."*

Index Nos.: 3121.01-16

Control No.: TR-32-364-92

Internal Revenue Service  
National Office Technical  
Advice Memorandum

KeyISSUE

Whether hogs received as compensation under an employment agreement, under the circumstances described below, are excepted from "wages" under Section 3121(a)(8)(A) of the Internal Revenue Code.

FACTS

Corporation is a family owned farm corporation that raises hogs primarily for sale as breeding stock. H and W are majority shareholders of Corporation and H is President of Corporation.

Corporation executed a written employment contract with H for the years in question. The contract specifies that for his services as farm manager, H is to be paid a cash salary of \$6,000 and, as additional compensation, 20 percent of all butcher hogs at market weight. A bonus of up to 20 head of boars weighing no more than 300 pounds may also be granted by H as President. In 1990, Corporation paid H \$6,000 in wages and \$34,941 in hogs and boars. In 1991 H received wages of \$11,000 in cash and \$41,272 in livestock. No Federal Insurance Contributions Act ("FICA") taxes were withheld or paid with respect to the hogs treated by H as compensation.



Exh 4-2 *continued*

Typically, when Corporation's butcher hogs were ready for market, 80 percent of the hogs were allocated to Corporation and 20 percent to H through the use of separate pens. Most of the time the butchers designated for H were taken to market a few days after being penned. On some occasions H's butchers were immediately sold along with the corporate butchers. This was done by delivering the butchers in a livestock trailer with a partition dividing H's hogs from the corporate hogs. A separate check was written by the buying station to each party.

The boars were primarily sold to individual buyers throughout the state. When Corporation granted H a bonus, these "bonus" boars were sometimes sold and delivered along with the corporate boars. In such a case, the boars were partitioned in Corporation's livestock trailer. The buyers issued separate checks to either H or Corporation depending on the ownership of the boars.

By the terms of the employment contract, H paid Corporation 20 cents a mile for transporting the hogs. At the end of each year, an adjusting journal entry was made to the corporate books to pick up the sales income for the butchers and boars given to H, and the related expense deduction for noncash wages paid to F

#### APPLICABLE LAW AND RATIONALE

Section 3121(a)(8)(A) of the Code provides that, for purposes of the Federal Insurance Contributions Act (FICA), the term "wages" does not include remuneration paid in any medium other than cash for agricultural labor [as defined in Section 3121(g)].

Section 31.3121(a)(8)-1(f) of the Employment Tax Regulations provides that cash remuneration includes checks and other monetary media of exchange. Cash remuneration does not include payments made in any other medium, such as lodging, food, clothing, car tokens, transportation passes or tickets, farm products, or other goods or commodities.

The incidence of taxation depends upon the substance of a transaction. The tax consequences that arise from a sale of property are not to be determined solely by the means employed to transfer legal title. See Commissioner v. Court Holding Co., 324 U.S. 331 (1945), 1945 C.B. 58, in which the United States Supreme Court upheld a Tax Court finding that a sale by stockholders of property conveyed to them as a "liquidating dividend" was in substance a sale by the corporation rather than by the stockholders.

Exh 4-2 *continued*

In Rev. Rul. 79-207, 1979-2 C.B. 351, a company paid its farm employees in commodity storage receipts rather than cash in order to avoid FICA taxes. The company immediately redeemed the employees' receipts for cash. The value of the storage receipts was equal to the amount that the employee would otherwise receive in cash. The revenue ruling concludes that the cash value of the commodity storage receipts paid to the farm employees is, in economic reality, a payment in cash. Thus, it is not excepted from wages under Section 3121(a)(8)(A) of the Code.

The nature of the transaction as encompassed in the employment agreement between H and Corporation is that H is receiving a cash payment. Other than some perfunctory steps taken to separate H's hogs and boars from those of Corporation, in reality the end result was the same, namely, the hogs and boars were sold for cash. It is clear that the employment contract was structured to eliminate the FICA taxes on a substantial portion of the compensation paid to H. We believe that substantively there is no significant difference between this case and Rev. Rul. 79-207.

#### CONCLUSION

Corporation's allocation of hogs to H pursuant to their employment agreement is equivalent to a payment of cash compensation and is therefore not excepted from wages for FICA purposes.

A copy of this technical advice memorandum is to be given the taxpayer. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

**EXHIBIT 4-3**

TAM 9403001

Index Nos.: 3121.01-16  
Control No.: CC:ESEO:Br2 - TR-32-126-93

**INTERNAL REVENUE SERVICE****NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM**

District Director,

Taxpayer's Name:  
Taxpayer's Address:

Taxpayer's Identification Number:  
Years Involved:  
Conference Held:

**KEY**

Taxpayer:

H:

W:

This memorandum is in response to your request for technical advice concerning the appropriate federal employment tax treatment of a portion of the salary paid to the employees of a corporation engaged in the business of farming.

**ISSUES**

1. Were payments made by the Taxpayer to H and W in the form of grain during the years in issue properly excluded from wages for purposes of Federal Insurance Contributions Act (FICA) taxes?
2. If the commodity wage payments were subject to FICA taxes, may the Taxpayer obtain an interest-free adjustment of the taxes under Section 6205 of the Internal Revenue Code?

**FACTS**

The Taxpayer is a corporation engaged in the farming business, primarily growing and harvesting grain. H and W are the only shareholders of the Taxpayer and are also treated as employees of the corporation. The Taxpayer files its federal tax returns as a C corporation.

The Taxpayer employed H and W under separate employment contracts. H was responsible for managing and operating the Taxpayer's business. He prepared an annual farm plan, supervised the preparation of seed beds, directed the time and method of planting, and performed other duties related to the operation of

Exh 4-3 *continued*

the farm. W kept personnel records, maintained financial books and records, prepared meals for all of the Taxpayer's employees, and acted in H's capacity when he was not present.

The Taxpayer paid H and W cash wages for services performed. The Taxpayer reported these wages on Form W-2 and withheld and paid FICA taxes on them. The Taxpayer also compensated H and W and all of its other employees in the form of grain. The grain payments were evidenced by documents describing the amount and type of grain transferred. The grain was valued at the time of the transfer and that amount was reported on the Form W-2 of H and W. The Taxpayer did not withhold or pay FICA taxes on these amounts.

The grain of H and W was neither stored separately from the grain of the Taxpayer nor were H and W charged for storing the grain in the Taxpayer's grain bins. H and W retained the grain for periods ranging from one and one-half to two and one-half months and bore the risk of gain or loss during that period. H and W located purchasers and negotiated sales on their own and received payments in their own names. H and W reported any gain from the sale of the grain on Schedule D.

Representatives of the Taxpayer concede that, at the time the commodity payments were made, it was intended that the grain would be converted to cash at some undetermined time in the future. The Taxpayer further concedes that its principal purpose in arranging commodity compensation was to select a form of compensation that was not subject to FICA taxes.

#### APPLICABLE LAW AND RATIONALE

##### FICA Wage Exception

Section 3121(a)(8)(A) of the Code provides that, for purposes of the FICA, the term "wages" does not include remuneration paid in any medium other than cash for agricultural labor [as defined in Section 3121(g)].

Section 31.3121(a)(8)-1(f) of the Employment Tax Regulations provides that cash remuneration includes checks and other monetary media of exchange. Cash remuneration does not include payments made in any other medium, such as lodging, food, clothing, car tokens, transportation passes or tickets, farm products, or other goods or commodities.

The incidence of taxation depends upon the substance of a transaction. The tax consequences that arise from a sale of property are not to be determined solely by the means employed to

Exh 4-3 *continued*

transfer legal title. See Commissioner v. Court Holding Co., 324 U.S. 331 (1945) C.B. 58, which upheld a Tax Court finding that a sale by stockholders of property conveyed to them as a "liquidating dividend" was in substance a sale by the corporation rather than by the stockholder. The Supreme Court stated that:

[T]he transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person can not be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

*Id.* at 59.

In Rev. Rul. 79-207, 1979-2 C.B. 351, a company paid its farm employees in commodity storage receipts rather than cash to avoid FICA taxes. The company immediately redeemed the employees' receipts for cash. The value of the storage receipts was equal to the amount that the employee would otherwise receive in cash. The ruling concludes that the cash value of the commodity storage receipts paid to the farm employees is, in economic reality, a payment in cash. Thus, it is not excepted from wages under Section 3121(a)(8) of the Code.

The determination of whether the exception from wages under Code Section 3121(a)(8)(A) applies depends upon whether, under the facts and circumstances viewed as a whole, a bona fide transfer of the noncash medium from the employer to the employee has occurred. If the facts and circumstances indicate, however, that the arrangement was simply a device to compensate the employee in cash but that noncash medium was used primarily to avoid FICA taxes, it is the position of the National Office that the arrangement lacks a business purpose and, thus, will not be respected.

Many factors may be relevant for purposes of determining whether a bona fide transfer of in-kind compensation has occurred. Following is a non-exclusive list of factors considered in this case: (1) whether the employer has transferred a readily identifiable portion of an item, (2) whether there is documentation of the transfer, (3) whether the in-kind payment is intended to be a substitute for cash, (4) whether the employee negotiates the subsequent sale of the item, (5) whether the risk of gain or loss is shifted to the employee, and (6) whether the employee bears the costs incident to ownership of the item, for example, storage, feeding, or maintenance costs.

Exh 4-3 *continued*

### Section 6205 Relief

Section 6205(a)(1) of the Code provides that an employer who has made an error and underpaid certain employment taxes shall correct the error in the manner prescribed by the regulations and no interest will be charged on the underpayment. Section 6205 applies to FICA taxes, Railroad Retirement Act taxes, and income taxes withholding. Federal Unemployment Tax Act taxes are not covered under Section 6205.

Section 31.6205-1(a)(1) of the regulations provides that an employer who has made an underpayment or undercollection of FICA tax with respect to any payment of wages or compensation shall correct the error as provided in this section. Section 31.6205-1(a)(4) provides that an error is ascertained when the employer has sufficient knowledge of the error to be able to correct it.

Rev. Rul. 75-464, 1975-2 C.B. 474, concluded that, under certain circumstances, the interest-free adjustment applies to employment tax controversies involving the erroneous characterization of employees as independent contractors. Rev. Rul. 86-10, 1986-1 C.B. 358, addressed the application of Section 6205 of the Code to an inadvertent failure to withhold. The ruling states that an employer has sufficient knowledge to ascertain an error if the employer disregards facts with the knowledge that there is a substantial possibility that further inquiry into such facts would result in the discovery of the error by the employer.

### CONCLUSIONS

#### FICA Wage Exception

Neither H nor W bore the costs incident to ownership of the grain, because the Taxpayer provided free storage in its grain bins. The grain of H and W was commingled with the grain of the Taxpayer and, thus, H and W did not receive identifiable portions of grain. Even though the employees waited over a month to sell their grain, it is clear from the Taxpayer's statement of facts that the intent at the time of the transfer was to convert the grain into cash. That the employees decided to wait does not alter this fact. Furthermore, H and W were the sole shareholders of the Taxpayer and as such were able to control the form of the compensation they paid themselves. The Taxpayer did not demonstrate a business reason to make the payments in a form other than cash and, in fact, admitted the payments were made in grain primarily to avoid FICA taxes. Accordingly, the transaction was in substance a payment of cash, which constitutes wages for FICA purposes.

Exh 4-3 *continued*

**Section 6205 Relief**

It is undisputed that the Taxpayer attempted to select a means of compensation that was not subject to FICA tax. The question is whether the regulations provide relief to a Taxpayer who makes a conscious decision not to pay cash wages solely to avoid FICA tax. We do not believe that this is the type of situation that the regulations were designed to address. Accordingly, the Taxpayer is not entitled to an interest-free adjustment under Section 6205 of the Code.

A copy of this technical advice memorandum is to be given the taxpayer. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

-END-

## EXHIBIT 4-4

TAM 8742007

Index No.: 1401.02-00  
 0162.07-02  
 Control No.: TR-32-85-87

INTERNAL REVENUE SERVICE

TAM 8742007

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

District Director

JUN 26 1987

Taxpayer's Name:  
 Taxpayer's Address:

Taxpayer's ID No.:  
 Tax Years Involved:  
 No Conference Held.

Legend

X =  
Y =  
Z =  
H =  
W =

This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code."

Issues:

1. Whether payments made to W by H in the operation of a farm represent the distribution of self-employment income.
2. Whether H is allowed a deduction under section 162 of the Code for salary payments made to W.

Facts:

Taxpayers, H and W, are farmers engaged in hog and cattle feeding and grain production. Together they own y acres of tillable land, z acres of which are owned solely in H's name and x acres of which are owned solely in W's name.

H began farming a portion of his land when he was employed by his father; he eventually purchased the farm in 1963. H and W were married in 1961.

In 1984 W purchased her x acres of land on contract at the recommendation of H and W's attorney, who suggested ownership in her name for estate planning purposes. However, the crops grown on W's land were commingled with the crops grown on the land of H.



Exh 4-4 *continued*

**H's activities in the farm operation included the following:**

- 1) All planting and crop rotation decisions, including selection of seed;
- 2) All decisions regarding chemicals, insecticide, fertilizer and herbicide applications, including product selection, purchase discount decisions, and decisions regarding timing and method of application and mixing;
- 3) Management of machinery maintenance schedule, repair decisions, and machinery replacement decisions and purchase/sale negotiation on all equipment and machinery;
- 4) All decisions regarding harvesting of crops, including both timing and method of harvesting, storage of crops, and trucking for market delivery;
- 5) All decisions regarding marketing and pricing of crops and negotiation of sales terms;
- 6) All decisions regarding hog and cattle purchases, including selection of animals and negotiation with selling agents;
- 7) All decisions regarding animal feeding, including rations and nutrient mixes;
- 8) All vaccination and animal health care decisions, including consultations with outside veterinarians;
- 9) All marketing and sales decisions with respect to hog and cattle disposition, and decisions regarding culling of animals;
- 10) Planning and projection of farm cash flow, and all control and management of farm disbursements and farm receipts; and
- 11) All negotiations and discussions with lenders regarding working capital debt and farm cash management.

The records of W indicate that during 1984 and 1985 she worked more than 30 hours per week, 52 weeks a year. Her duties included bookkeeping, attending agricultural functions, purchasing supplies, harvesting crops, checking and operating farm machinery, assisting in the sale of pigs, and various other errands and chores.

Exh 4-4 *continued*

[REDACTED]

The farm income and expenses (including the interest and real estate taxes on W's land) were reported on Schedule F with H & W's joint tax return for 1984 and 1985. The Schedule F was in both names in 1984 but only in H's name in 1985. For both years the monies paid to W were deducted on the appropriate line for "labor hired" on the Schedule F. The receipt of income by W was reported in 1984 on line 22 of the 1984 Form 1040 and described as "wife's farm wages". For 1985, H issued W a Form W-2 and income was reported on line 1 of the Form 1040. The difference in reporting is attributable to the fact that taxpayers changed income tax preparers, and the latter tax return preparer recommended the filing of the Form W-2 for all wages paid by H to family members. The Schedule F was in both names in 1984 but only in H's name in 1985. Also included with each return was a completed Schedule SE, Computation of Social Security Self-Employment Tax, in the name of H only.

H and W owned a joint bank account, over which both had signature authority, in which was deposited income from the farm and income from other sources. All expenses, including both farm and personal expenses of H and W, were paid from this joint account.

W paid no rent to H for use of H's land. However, as compensation for work performed, H made a lump sum payment to W at the end of each year. The amount was determined on the basis of actual hours of work performed multiplied by a rate of \$6.50 per hour. The salary checks were drawn by H from the joint account and redeposited in the account by W shortly thereafter. W reported the salary payment in gross income but no self-employment taxes or Federal Insurance Contributions Act (FICA) taxes were paid by H or W on this amount.

#### Applicable Law and Rationale

Initially, a determination must be made whether a partnership existed between H and W. If there was a partnership the distributions to both H and W from farm income were distributions of self-employment income. This is so because section 1401 of the Internal Revenue Code imposes taxes under the Self-Employment Contributions Act (SECA) on the "self-employment income" of every individual.

Section 1402(b) of the Code defines "self-employment income" as an individual's "net earnings from self-employment", subject to certain limitations and conditions.

Exh 4-4 continued

Section 1402(a) of the Code defines "net earnings from self-employment" to mean, subject to certain conditions and limitations, the gross income derived by an individual from a "trade or business" less the deductions allowed by law attributable to such trade or business, plus the individual's distributive share of income or loss from a trade or business carried on as a member of a partnership.

In addition, Rev. Rul. 82-39, 1982-1 C.B. 119, in applying the rules of section 1402(a) of the Code to both community and non-community property states, concludes that in the absence of a partnership, only the spouse carrying on the trade or business will be subject to the self-employment taxes imposed under section 1401.

Section 7701(a)(2) of the Code provides that the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not for federal tax purposes, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

Whether parties have formed a joint venture is a question of fact to be determined by reference to the same principles that govern the question of whether persons have formed a partnership which is to be accorded recognition for tax purposes. Therefore, while all circumstances are to be considered, the essential question is whether the parties intended to, and did in fact, join together for the present conduct of an undertaking or enterprise. The following factors, none of which is conclusive, are evidence of this intent: (1) the agreement of the parties and their conduct in executing its terms; (2) the contributions, if any, that each party makes to the venture, (3) control over the income and capital of the venture and the right to make withdrawals; (4) whether the parties are co-proprietors who share in net profits and who have an obligation to share losses; and (5) whether the business was conducted in the joint names of the parties and was represented to be a partnership. See Commissioner v. Tower, 327 U.S. 280 (1946), 1946-1 C.B. 11; Commissioner v. Culbertson, 337 U.S. 733 (1949), 1949-2 C.B. 5; Luna v. Commissioner, 42 T.C. 1067 (1964); and Rev. Rul. 82-61, 1982-1 C.B. 13.

Section 704(e) of the Code deals specifically with family partnerships. Section 704(e)(1) provides that a person shall be recognized as a partner for purposes of federal income taxes if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

Exh 4-4 continued

Section 1.704-1(e)(1)(iv) of the Income Tax Regulations provides, in part, that for purposes of section 704(e)(1) of the Code, capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership. Capital is ordinarily a material income-producing factor if the operation of the business requires substantial inventories or a substantial investment in plant, machinery, or other equipment.

Section 1.704-1(e)(1)(v) of the regulations provides that for purposes of section 704(e) of the Code, a capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon limitation of the partnership. The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership.

Section 1.704-1(e)(2) of the regulations lists a series of factors to be considered in determining whether a partner is, in fact, the real owner of a capital interest in a partnership. The factors to be considered, which are illustrative rather than exhaustive, break down into five categories: retained controls (including retention of control of assets essential to the business), indirect controls, participation in management, income distributions, and conduct of partnership business. The first two factors indicate lack of ownership, while the last three factors indicate ownership.

In United States v. Ramos, 393 F. 2d 618 (9th Cir. 1968), cert. denied, 393 U.S. 983, an alleged family partnership was found to be invalid under section 704(e) of the Code where the taxpayer-parents retained the complete interests in the operating assets of a ranch, and the children contributed neither property nor services except bookkeeping services, for which compensation was paid for such services. The failure of the parents to transfer title to farmland to the partnership was one of the most important factors in the court's decision not to recognize the partnership.

The following factors, none of which by itself is controlling, weigh against the finding of a partnership under sections 7701(a)(1) or 704(e) of the Code. First, neither H or W transferred title to his or her farmland into the name of the farm business or into a joint tenancy; thus, each retained dominion and control over his or her own property. Second, W kept records of the hours she worked on the farm, and all amounts paid to W were based on those records rather than on a

Exh 4-4 continued

percentage of the farm income corresponding to W's share of the land farmed. Third, the x acres of farmland were purchased in W's name for estate planning purposes, not for the purpose of contributing the land to a partnership. Fourth, the farming business had been conducted by H for more than 20 years prior to the time that W's land was used in the business; the economic relationship of the parties remained the same afterwards as before. Other factors which tend to indicate that no partnership existed for federal tax purposes are that there was no formal partnership agreement under which the two were to share profits and expenses; there is no evidence that the couple have held themselves out to third parties as partners; and it appears that H retained the management powers in the business. The fact that W performed services in H's farming business and that she allowed her own land to be used in that business does not necessarily establish a partnership for federal tax purposes. The Service recognizes that there may be a mere uncompensated loan of property, particularly between spouses. The Service also recognizes that one spouse can provide services in the business of the other spouse in a capacity other than as a partner. Finally, it is not unusual in a family business operation for both spouses to have signature authority over a bank account which is used for both personal and business matters.

Therefore, we conclude that no partnership existed between H and W.

The issue also arises as to whether W was an employee of H in the performance of farm activities. This determination is necessary because, for SECA purposes, section 1402(c)(2) of the Code provides that the performance of services as an employee does not constitute a "trade or business" within the meaning of section 1402(a).

Sections 31.3121(d)-1, 31.3306(i)-1, and 31.3401(c)-1 of the Employment Tax Regulations provide that generally the relationship of employer and employee exists when the person for whom the services are performed has the right to control and direct the individual not only as to the result to be accomplished by the work but also as to the details and means by which the result is accomplished.

Based on the information furnished, it appears that W merely assisted H with farm activities and H had the right to exercise direction and control over W while she performed her duties. Thus, we conclude that W was an employee of H in the performance of services in H's farm business and those services did not constitute a "trade or business" under section 1402(a) of the Code.

Exh 4-4 *continued*

████████████████████

Lastly, we will address the issue of the deductibility under section 162 of the Code of the payments made by H to W.

Section 162(a)(1) of the Code provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the tax year on carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered. See also section 1.162-7 of the regulations.

The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. Thus, in Rev. Rul. 73-393, 1973-2 C.B. 33, the Service held that reasonable wages paid by a father to his child for services actually rendered as a bona fide employee are deductible as ordinary and necessary expenses under section 162 of the Code. As the revenue ruling indicates, the criteria to be used in making a determination as to the deductibility of a salary payment between related parties is whether actual services have been rendered, whether the amount paid is reasonable, whether there was an actual or constructive payment made, and whether there was an employee-employer relationship in existence for which an ordinary and necessary business expense had been incurred.

In Stradley v. Commissioner, T.C. Memo 1986-424, no amount was deductible as a business expense for salary paid to taxpayer's wife for secretarial services because there was no evidence of an employment relationship or an actual payment of salary. See also Tinkoff v. Commissioner, 120 F. 2d 564 (1941), in which an amount allegedly paid to the taxpayer's wife was not deductible because the wife performed no services and the checks drawn in her favor were cancelled and never paid. In the instant case, there is no dispute as to the fact that W performed valuable services on a regular basis for H, that payment was made and that an employer-employee relationship existed.

### Conclusion

1. The payments made to W by H in 1984 and 1985 do not constitute self-employment income distributed to W for SECA purposes.

2. H is allowed a deduction under section 162 of the Code for salary payments made to W.

-END-

**EXHIBIT 4-5**

**SAMPLE FORM W-2 FOR COMMODITY WAGES**

a Control number <b>22222</b>		Void <input type="checkbox"/>	For Official Use Only ▶ OMB No. 1545-0008			
b Employer identification number <b>41-1111111</b>		1 Wages, tips, other compensation <b>15,475.00</b>		2 Federal income tax withheld <b>0</b>		
c Employer's name, address, and ZIP code <b>South Gate Farms                  George Hanson                  RR 1                  Anytown, MN 56666</b>		3 Social security wages <b>0</b>		4 Social security tax withheld		
		5 Medicare wages and tips		6 Medicare tax withheld		
		7 Social security tips		8 Allocated tips		
d Employee's social security number <b>41-22-3333</b>		9 Advance EIC payment		10 Dependent care benefits		
e Employee's name (first, middle initial, last) <b>Michael Weston</b> <hr/> <b>RR 1 Anytown, MN 56666</b>		11 Nonqualified plans		12 Benefits included in box 1		
		13 See instrs. for box 13		14 Other Payment in commodities		
f Employee's address and ZIP code		15 Statutory employee <input type="checkbox"/>	Deceased <input type="checkbox"/>	Pension plan <input type="checkbox"/>	Legal rep. <input type="checkbox"/>	Defered compensation <input type="checkbox"/>
16 See Employer's state I.D. no.	17 See wages, tips, etc. <b>15,475.00</b>	18 State income tax	19 Locality name	20 Local wages, tips, etc.	21 Local income tax	

**W-2 Wage and Tax Statement 1998**

Department of the Treasury—Internal Revenue Service  
For Privacy Act and Paperwork Reduction Act Notice, see separate instructions.

Copy A For Social Security Administration—Send this entire page with Form W-3 to the Social Security Administration; photocopies are Not acceptable.

Cat. No. 10134D

**Do NOT Cut, Staple, or Separate Forms on This Page Do NOT Cut, Staple, or Separate Forms on This Page**

**EXHIBIT 4-6**

**SCHEDULE D  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service (99)

**Capital Gains and Losses**

▶ Attach to Form 1040. ▶ See instructions for Schedule D (Form 1040).

▶ Use Schedule D-1 for more space to list transactions for lines 1 and 8.

OMB No. 1545-0074

**1997**

Attachment  
Sequence No. 12

Name(s) shown on Form 1040

Year social security number

**Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less**

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-3)	(e) Cost or other basis (see page D-4)	(f) GAIN or (LOSS) FOR ENTIRE YEAR. Subtract (e) from (d)	
1						
2	Enter your short-term totals, if any, from Schedule D-1, line 2 . . . . .		2			
3	Total short-term sales price amounts. Add column (d) of lines 1 and 2 . . . . .		3			
4	Short-term gain from Forms 2119 and 6252, and short-term gain or (loss) from Forms 4684, 6781, and 8824 . . . . .				4	
5	Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . . . .				5	
6	Short-term capital loss carryover. Enter the amount, if any, from line 9 of your 1996 Capital Loss Carryover Worksheet . . . . .				6	( )
7	Net short-term capital gain or (loss). Combine lines 1 through 6 in column (f). ▶				7	

**Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year**

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-3)	(e) Cost or other basis (see page D-4)	(f) GAIN or (LOSS) FOR ENTIRE YEAR. Subtract (e) from (d)	(g) 28% RATE GAIN or (LOSS) (see instr. below)
8						
9	Enter your long-term totals, if any, from Schedule D-1, line 9 . . . . .		9			
10	Total long-term sales price amounts. Add column (d) of lines 8 and 9 . . . . .		10			
11	Gain from Form 4797, Part I; long-term gain from Forms 2119, 2439, and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824 . . . . .				11	
12	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . . . .				12	
13	Capital gain distributions . . . . .				13	
14	Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 14 of your 1996 Capital Loss Carryover Worksheet . . . . .				14	( ) ( )
15	Combine lines 8 through 14 in column (g) . . . . .				15	
16	Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f). ▶				16	

\* 28% Rate Gain or Loss includes all gains and losses in Part II, column (f) from sales, exchanges, or conversions (including installment payments received) either: • Before May 7, 1997, or

• After July 28, 1997, for assets held more than 1 year but not more than 18 months.

It also includes ALL "collectibles gains and losses" (as defined on page D-4).



**Part III Summary of Parts I and II**

<b>17</b>	Combine lines 7 and 16. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13 <b>Next:</b> Complete Form 1040 through line 38. Then, go to <b>Part IV</b> to figure your tax if: • Both lines 16 and 17 are gains, and • Form 1040, line 38, is more than zero.	<b>17</b>	
<b>18</b>	If line 17 is a loss, enter here and as a (loss) on Form 1040, line 13, the <b>smaller</b> of these losses: • The loss on line 17; or • (\$3,000) or, if married filing separately, (\$1,500) <b>Next:</b> Complete Form 1040 through line 36. Then, complete the <b>Capital Loss Carryover Worksheet</b> on page D-4 if: • The loss on line 17 exceeds the loss on line 18, or • Form 1040, line 36, is a loss.	<b>18</b> (	)

**Part IV Tax Computation Using Maximum Capital Gains Rates**

<b>19</b>	Enter your taxable income from Form 1040, line 38	<b>19</b>	
<b>20</b>	Enter the <b>smaller</b> of line 16 or line 17	<b>20</b>	
<b>21</b>	If you are filing Form 4952, enter the amount from Form 4952, line 4e	<b>21</b>	
<b>22</b>	Subtract line 21 from line 20. If zero or less, enter -0-	<b>22</b>	
<b>23</b>	Combine lines 7 and 15. If zero or less, enter -0-	<b>23</b>	
<b>24</b>	Enter the <b>smaller</b> of line 15 or line 23, but not less than zero	<b>24</b>	
<b>25</b>	Enter your unrecaptured section 1250 gain, if any (see page D-4)	<b>25</b>	
<b>26</b>	Add lines 24 and 25	<b>26</b>	
<b>27</b>	Subtract line 26 from line 22. If zero or less, enter -0-	<b>27</b>	
<b>28</b>	Subtract line 27 from line 19. If zero or less, enter -0-	<b>28</b>	
<b>29</b>	Enter the <b>smaller</b> of line 19 or \$41,200 (\$24,650 if single; \$20,600 if married filing separately; \$33,050 if head of household)	<b>29</b>	
<b>30</b>	Enter the <b>smaller</b> of line 28 or line 29	<b>30</b>	
<b>31</b>	Subtract line 22 from line 19. If zero or less, enter -0-	<b>31</b>	
<b>32</b>	Enter the <b>larger</b> of line 30 or line 31	<b>32</b>	
<b>33</b>	Figure the tax on the amount on line 32. Use the Tax Table or Tax Rate Schedules, whichever applies	<b>33</b>	
<b>34</b>	Enter the amount from line 29	<b>34</b>	
<b>35</b>	Enter the amount from line 28	<b>35</b>	
<b>36</b>	Subtract line 35 from line 34. If zero or less, enter -0-	<b>36</b>	
<b>37</b>	Multiply line 36 by 10% (.10)	<b>37</b>	
<b>38</b>	Enter the <b>smaller</b> of line 19 or line 27	<b>38</b>	
<b>39</b>	Enter the amount from line 36	<b>39</b>	
<b>40</b>	Subtract line 39 from line 38. If zero or less, enter -0-	<b>40</b>	
<b>41</b>	Multiply line 40 by 20% (.20)	<b>41</b>	
<b>42</b>	Enter the <b>smaller</b> of line 22 or line 25	<b>42</b>	
<b>43</b>	Add lines 22 and 32	<b>43</b>	
<b>44</b>	Enter the amount from line 19	<b>44</b>	
<b>45</b>	Subtract line 44 from line 43. If zero or less, enter -0-	<b>45</b>	
<b>46</b>	Subtract line 45 from line 42. If zero or less, enter -0-	<b>46</b>	
<b>47</b>	Multiply line 46 by 25% (.25)	<b>47</b>	
<b>48</b>	Enter the amount from line 19	<b>48</b>	
<b>49</b>	Add lines 32, 36, 40, and 46	<b>49</b>	
<b>50</b>	Subtract line 49 from line 48	<b>50</b>	
<b>51</b>	Multiply line 50 by 28% (.28)	<b>51</b>	
<b>52</b>	Add lines 33, 37, 41, 47, and 51	<b>52</b>	
<b>53</b>	Figure the tax on the amount on line 19. Use the Tax Table or Tax Rate Schedules, whichever applies	<b>53</b>	
<b>54</b>	<b>Tax.</b> Enter the <b>smaller</b> of line 52 or line 53 here and on Form 1040, line 39	<b>54</b>	

EXHIBIT 4-7

SAMPLE SCHEDULE F REPORTING OF COMMODITY WAGES

SCHEDULE F (Form 1040)

Profit or Loss From Farming

OMB No. 1545-0074

1997

Attachment Sequence No. 14

Department of the Treasury Internal Revenue Service (99)

Attach to Form 1040, Form 1041, or Form 1065.

See Instructions for Schedule F (Form 1040).

Name of proprietor, Social security number (SSN), Principal product, Accounting method, and material participation checkboxes.

E Did you "materially participate" in the operation of this business during 1997? If "No," see page F-2 for limit on passive losses. Yes No

Part I Farm Income—Cash Method. Complete Parts I and II (Accrual method taxpayers complete Parts II and III, and line 11 of Part I.) Do not include sales of livestock held for draft, breeding, sport, or dairy purposes; report these sales on Form 4797.

Table with 11 rows for Farm Income. Line 10 includes handwritten '15,475 00' and 'Commodity Adjustments'.

Part II Farm Expenses—Cash and Accrual Method. Do not include personal or living expenses such as taxes, insurance, repairs, etc., on your home.

Table with 34 rows for Farm Expenses. Line 24 includes handwritten '15,475 00'.

Summary lines 35-37 including Total expenses, Net farm profit or loss, and investment risk checkboxes.

**Part III Farm Income—Accrual Method** (see page F-5)

**Do not include sales of livestock held for draft, breeding, sport, or dairy purposes; report these sales on Form 4797 and do not include this livestock on line 46 below.**

38	Sales of livestock, produce, grains, and other products during the year . . . . .			38	
39a	Total cooperative distributions (Form(s) 1099-PATR)	39a		39b	Taxable amount
40a	Agricultural program payments . . . . .	40a		40b	Taxable amount
41	Commodity Credit Corporation (CCC) loans:				
a	CCC loans reported under election . . . . .			41a	
b	CCC loans forfeited . . . . .	41b		41c	Taxable amount
42	Crop insurance proceeds . . . . .			42	
43	Custom hire (machine work) income . . . . .			43	
44	Other income, including Federal and state gasoline or fuel tax credit or refund . . . . .			44	
45	Add amounts in the right column for lines 38 through 44 . . . . .			45	
46	Inventory of livestock, produce, grains, and other products at beginning of the year . . . . .	46			
47	Cost of livestock, produce, grains, and other products purchased during the year . . . . .	47			
48	Add lines 46 and 47 . . . . .	48			
49	Inventory of livestock, produce, grains, and other products at end of year	49			
50	Cost of livestock, produce, grains, and other products sold. Subtract line 49 from line 48* . . . . .			50	
51	<b>Gross income.</b> Subtract line 50 from line 45. Enter the result here and on page 1, line 11 . . . . . ▶			51	

\*If you use the unit-livestock-price method or the farm-price method of valuing inventory and the amount on line 49 is larger than the amount on line 48, subtract line 48 from line 49. Enter the result on line 50. Add lines 45 and 50. Enter the total on line 51.

**Part IV Principal Agricultural Activity Codes**

**Caution:** File *Schedule C (Form 1040), Profit or Loss From Business*, or *Schedule C-EZ (Form 1040), Net Profit From Business*, instead of *Schedule F* if:

- Your principal source of income is from providing agricultural services such as soil preparation, veterinary, farm labor, horticultural, or management for a fee or on a contract basis, or
- You are engaged in the business of breeding, raising, and caring for dogs, cats, or other pet animals.

Select one of the following codes and write the 3-digit number on page 1, line B:

- 120 **Field crop**, including grains and nongrains such as cotton, peanuts, feed corn, wheat, tobacco, Irish potatoes, etc.
- 160 **Vegetables and melons**, garden-type vegetables and melons, such as sweet corn, tomatoes, squash, etc.
- 170 **Fruit and tree nuts**, including grapes, berries, olives, etc.
- 180 **Ornamental floriculture and nursery products**

- 185 **Food crops grown under cover**, including hydroponic crops
- 211 **Beefcattle feedlots**
- 212 **Beefcattle**, except feedlots
- 215 **Hogs, sheep, and goats**
- 240 **Dairy**
- 250 **Poultry and eggs**, including chickens, ducks, pigeons, quail, etc.
- 260 **General livestock**, not specializing in any one livestock category
- 270 **Animal specialty**, including bees, fur-bearing animals, horses, snakes, etc.
- 280 **Animal aquaculture**, including fish, shellfish, mollusks, frogs, etc., produced within confined space
- 290 **Forest products**, including forest nurseries and seed gathering, extraction of pine gum, and gathering of forest products
- 300 **Agricultural production**, not specified



## EXHIBIT 4-8

### REQUIRED GUIDELINES FOR PAYMENT OF WAGES IN FARM COMMODITIES

- A. Must have a completed "Employment Agreement" for each employee.

The employment agreement clarifies the employee status of the arrangement, and prevents the IRS from recharacterizing the commodity payments. If you presently do not have a written agreement in place, we can assist in working with your attorney to establish such an agreement.

- B. Must keep records of commodities to be paid and how much was paid on an annual basis. Computation of amount to be paid must comply with terms in the "Employment Agreement" (see sample worksheet attached). *Do not* sell commodity back to employer.

- C. *Must document transfer of ownership to employee prior to sale of commodity.* (Caution: Remember this is a *two-step* process: (1) The employer pays the employee in commodity, and (2) The employee sells the commodity.)

1. Grain stored on farm should have the transfer documented by a written statement or "bill of sale" between employer and employee stating (see sample statement attached):

Date of transfer;

Commodity transferred;

Quantity of commodity transferred; and

Value of commodity (to be used for W-2).

2. Livestock transferred should be documented in the same manner as on-farm stored grain indicated above. The same statement should be prepared.
3. Grain delivered or stored at elevator must be documented by a warehouse receipt, or similar documents, in employee's name prior to sale (This is *essential* evidence to show that the first step of the two-step process actually occurred).
4. After the date of transfer from employer to employee, any costs of storage, maintenance or shipping for sale of the commodity are the responsibility of the employee, and should be paid by the employee.

D. The commodity is taxable wage income to the employee on the date of transfer, regardless of when later sold by the employee.

E. Example:

1. Agreement states employee is to receive 5% of annual soybean production.
2. Employer's 1998 soybean production is 8,000 bushels (200 acres × 40 bu./acre).
3. Employee's share is 400 bushels (8,000 bushel × 5%).
4. Employer transfers crop to employee as follows:

Date	Value	Quantity	Balance
1998			400 bu.
10/05/98	\$1,200	200 bu.	200 bu.
10/20/98	700	100 bu.	100 bu.
10/25/98	750	100 bu.	—
Total	<u>\$2,650</u>		

5. Employer reports \$2,650 as soybeans sold with an offsetting \$2,650 wage deduction.
6. Employer provides the employee with a Form W-2 which includes the \$2,650 as wages, along with any cash wages paid.
7. Employee must report and pay federal and state income tax (but not social security tax) on the \$2,650 (the employee may want to consider paying estimated tax payments to avoid underpayment penalties).
8. If the employee later sells the grain for \$2,800, a gain of \$150 is reported by the employee for the year of sale.

F. Why use commodities?

Value of commodities is not subject to any social security taxes by either the employer or the employee.

- a. Be sure above guidelines are followed.
- b. *Note* effect this may have on future social security benefits which, of course, may be reduced.

G. Wages paid in commodities are still subject to workers' compensation insurance for covered employees.



Total Value for Year \$ \_\_\_\_\_  
(Report on Form W-2)

- Notes:**
1. Be sure to carry over any unpaid quantity to next year.
  2. Be sure to carry over any overpayment in quantity to next year.
  3. Do not sell commodity back to employer.
  4. Return a copy of this form to your accountant at year-end.

**EXHIBIT 4-10****NONCASH REMUNERATION FOR AGRICULTURAL LABOR****Noncash Remuneration for Agricultural Labor****I.R.C. § 3121(a)(8)(A)****I. INTRODUCTION**

The purpose of these guidelines is to assist examiners, taxpayers, and practitioners in determining whether in-kind payments for agricultural labor constitute "wages" for federal employment tax purposes. This document describes the legislative background and development of the controversy, sets forth the current employment tax statutes and regulations pertaining to noncash remuneration, explores the application of the common law "substance over form" doctrine to this issue, and identifies factors that are relevant to an analysis of this type of transaction. The document concludes with a brief discussion of the reporting and income tax obligations of employers and employees in connection with noncash remuneration.

Remuneration paid in any medium other than cash for agricultural labor is generally excluded from "wages" for Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), and federal income tax withholding purposes. Although employers and employees may achieve tax savings through in-kind compensation under these provisions, the employees' social security benefits can be correspondingly reduced or eliminated.

Whether putative noncash payments are, in substance, equivalent to cash payments has become a contentious issue between the Internal Revenue Service and members of the farm community. The inherently factual nature of the "substance over form" analysis has prompted many to criticize the Service for applying the law inconsistently. A review of cases in the Des Moines District revealed, however, that the Service raised a valid issue in 90 to 95 percent of the cases. Most of these cases involved a proximate cash transaction, *i.e.*, the in-kind payment was made nearly simultaneously with the sale of the commodity without the service provider actually exercising dominion and control over the commodity. Thus, although the payments may have been noncash in form, they were cash in substance.

Because formal guidance on the application of the "substance over form" doctrine to this issue is lacking, a task force representing the farm community and the Service convened to produce additional guidance. The Compliance 2000 philosophy of reducing taxpayer and Service



Exh 4-10 *continued*

burdens and resolving issues by means other than enforcement provided the impetus for the task force and this document.

The following information is intended to educate examiners, taxpayers, and practitioners. It does not represent a binding position on any party as the facts and circumstances of each case determine whether a payment constitutes "wages" for employment tax purposes. Nevertheless, we believe this document contains useful information for taxpayers and practitioners attempting to comply with the law and for Service personnel attempting to enforce the law equitably and consistently.

## II. BACKGROUND

Agricultural labor was first brought under the social security system by Public Law 734, the Social Security Amendments of 1950. Public Law 761, the Social Security Amendments of 1954, expanded coverage to self-employed farmers. Public Law 880, the Social Security Amendments of 1955, was enacted, in part, to clarify the treatment of sharefarming arrangements.

Congress enacted the current employment tax wage exception for noncash remuneration for agricultural labor in Public Law 734. In creating this exception, Congress was addressing Treasury's interpretation of existing law, which did not specifically exclude meals and lodging provided for the convenience of the employer from wages. See H.R. Rep. No. 1189, 1956-2 C.B. 1248, 1259. Mim. 5657, 1944 C.B. 550, held that meals and lodging provided for the convenience of the employer, which were excluded from gross income, were wages for FICA purposes.

Congress was also concerned about record keeping burdens on agricultural employers. See H.R. Rep. No. 1698, 1954-2 C.B. 676, 680-681. The legislative history supports the view that Congress was aware that farm employers commonly provided employees with meals and lodging and that there would be significant associated record keeping burdens were meals and lodging not excluded from wages. Notwithstanding this point, section 3121(a)(8)(A) of the Code, as enacted, did not limit the exclusion from payroll taxes to meals and lodging.

Exh 4-10 *continued*

### III. APPLICABLE LAW

#### A. Statutory Authority

Under sections 3121(a)(8)(A), 3306(b)(11), and 3401(a)(2) of the Internal Revenue Code, remuneration paid in any medium other than cash for "agricultural labor" is excluded from "wages" for FICA, FUTA, and income tax withholding purposes. Accordingly, remuneration paid to employees for agricultural labor, which would otherwise be subject to employment taxes, is statutorily excepted from these taxes.

To qualify under this provision, the services performed must be "agricultural labor" within the meaning of section 3121(g) of the Code.<sup>1</sup> In general, the term includes all services performed on a farm in connection with the raising or harvesting of agricultural or horticultural commodities. Also included are services performed in connection with the operation, management, conservation, improvement, or maintenance of the farm and its tools and equipment.

#### B. "Substance Over Form" Analysis

The incidence of taxation depends upon the substance of a transaction. The tax consequences arising from a sale or other disposition of property are not determined solely by the means employed to transfer legal title. The leading "substance over form" case is Commissioner v. Court Holding Co., 324 U.S. 331 (1945), 1945 C.B. 58. In that case, the Supreme Court stated that:

[T]he transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person can not be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

Id. at 59.

The determination of whether the exception from wages under Code section 3121(a)(8)(A) applies depends upon whether, under the facts and circumstances viewed as a whole, a bona fide transfer of the noncash medium from the employer to the employee has occurred. Although many

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<sup>1</sup> Sections 3306(k) and 3402(a)(2) of the Code cross-reference section 3121(g) for FUTA and income tax withholding purposes.

Exh 4–10 *continued*

factors may be relevant for purposes of determining whether a bona fide transfer of in-kind compensation has occurred, the inquiry can be reduced to two components: whether the employee exercises dominion and control over the commodity, and whether the payment is equivalent to cash.

Other factors may be present in a particular case that tend to establish that the in-kind payment was without substance and was made with the principal purpose of avoiding employment taxes. For example, evidence that the employer was purchasing farm products on the open market for purposes of making in-kind payments is a strong indication that the arrangement lacks substance. A farm employer that produces both hogs and corn, for instance, could use raised feeder pigs or corn to compensate its employees. Remuneration paid in some other medium that was purchased solely to compensate the employee would not be excluded from wages under section 3121(a)(8)(A) of the Code. This and other factors should be weighed with other evidence in determining whether a bona fide transfer of noncash remuneration occurred.

*1. Exercise of Dominion and Control by the Employee*

Whether an employee has exercised dominion and control over a commodity depends on the facts and circumstances surrounding the transfer of that commodity. Examiners should look at objective factors to determine whether the employer has relinquished dominion and control and whether the employee has exercised dominion and control. Relevant factors include: (1) existence and extent of documentation, (2) marketing and negotiation of the subsequent sale of the commodity by the employee, (3) shifting the risk of gain or loss to the employee, (4) the length of time between the employee's receipt and sale of the commodity, (5) bearing the costs incident to ownership, and (6) ready identifiability of the transferred commodity.

**a. Documentation.** As is the case with most tax issues, documentation of a transaction enables examiners to better understand and analyze the transaction. Documentation also offers evidence of the parties' intent upon entering the transaction. Nevertheless, it is always the examiner's job to look behind the documents to determine whether the substance of the transaction is in accord with its written form. Documentation of both the employment

Exh 4-10 *continued*

relationship, including compensation practices, and the transfer of commodities is extremely important evidence in establishing a bona fide transfer of noncash remuneration.

*Evidence of Transfer.* Commodities typically used to compensate employees include livestock, grain, breeding rights, and milk products. Written evidence of transfer of these commodities is essential. Receipts, contracts, bills of sale, and other instruments of conveyance vary according to the type of commodity involved, but all are useful indicia of transfer. Other related documentation is also important, including sales records, weigh tickets, required veterinary inspection certificates, and maintenance receipts reflecting that recipients have incurred storage and feed costs. Breeding certificates and formal registration records are important reflections of true transfers of breeding rights and registered animals.

The release of any security interests that a lender may have in the farm employer's commodities is also crucial to completing a transfer. In many instances, farmers will have ongoing lines of credit with local lenders, and the sale and transfer of property securing the loan can only be accomplished through formal release of the security interest by the lender. It is important for IRS examiners to determine whether the employer followed these formal prerequisites to completing a valid transfer. Failure of the employer to inform the lender that the commodity is being transferred suggests that the commodities remain under the dominion and control of the employer.

Although a farmer-originated bill of sale, receipt, or other documentation is evidence of transfer, the substance of the transaction must also indicate that a transfer has occurred. For example, the employee's failure to pay the costs associated with storing or maintaining the commodity indicates that a substantive transfer has not occurred.

Documents evidencing transfer that are functionally equivalent to cash are considered to be cash. For example, a scale ticket issued by a grain elevator acknowledging its receipt of grain would not normally be convertible to cash, but it does reflect an identifiable amount of grain. In contrast, a warehouse receipt, or some variation, issued by a grain elevator is frequently treated as negotiable. Payment by such a readily negotiable document would likely be deemed to be the

Exh 4-10 *continued*

functional equivalent of cash and not covered by section 3121(a)(8)(A). See Rev. Rul. 79-207, 1979-2 C.B. 351. This topic is discussed in greater detail below.

*Employment Contract.* Clearly, for the employment tax exception for noncash remuneration paid for agricultural labor to apply, an employment relationship must exist. See, e.g., Rev. Rul. 56-659, 1956-2 C.B. 332 (dealing with sharefarming arrangements); Crawford v. Commissioner, T.C. Memo. 1984-433 (dealing with partnerships). Only payments to an employee qualify for this employment tax exception. An individual receiving an in-kind payment as a self-employed individual, within the meaning of section 1402 of the Code, is subject to Self-Employment Compensation Act (SECA) tax. The services performed by the employee must be "agricultural labor," as defined in section 3121(g). A description of the employee's duties in a contract helps to determine whether these duties constitute "agricultural labor."

These requirements having been met, documentation of the wage payment agreement is a factor, though not bearing sufficient weight to override the substance of a transaction, to be considered in determining whether a purported in-kind payment represents a bona fide payment of noncash compensation. Stated more succinctly, the substance of the in-kind payment cannot merely be "papered" to obtain the benefit of section 3121(a)(8)(A).

A substantive arrangement to make in-kind compensation payments will ideally be described formally in a written contract or employment agreement. In addition to employment contracts, corporate minutes or resolutions reflecting a formal adoption of the program may also provide some indication that in-kind payments were not, in substance, cash payments.

Anything in the way of a posted employee announcement or any written documents describing the program should be requested. The absence of any of these documents about a program to compensate employees through agricultural commodities could reflect an effort to avoid paying employment taxes or the existence of a partnership or tenant relationship. It is important to note that a farmer may have different types of workers, including mechanics, truckers, or other "outside" workers, and these guidelines may apply differently to each type of worker. Again, this discussion of documentation is in no way intended to imply that the

Exh 4-10 *continued*

substance of a transaction that would not otherwise withstand scrutiny may be merely documented to obtain the benefits of section 3121(a)(8)(A).

**b. Employee Marketing and Negotiation of the Sale of the Commodities.**

Independent sales transactions by the employee are important. Failure of the employee to negotiate an independent sale reflects a failure by the employee to exercise dominion and control over the commodity and could indicate that a bona fide transfer has not occurred.

After a transfer to the employee has occurred, the employer must not act in concert with the employee in management, maintenance, or marketing and disposition of the transferred commodity. If any portion of this decision-making process remains with the employer, a rebuttable presumption that a transfer has not been completed is created. For example, the employer may not direct the elevator/purchaser to issue a check for a given quantity of grain or livestock that is payable to the employee. Such action reflects a failure by the employee to exercise dominion and control. However, this does not preclude the employee from contracting with the employer for such services in an arm's-length transaction.

If the sale of the commodity by the farm employer is in unison with the disposition of the employees' commodities, the entire arrangement suggests that the parties are merely deferring the receipt of cash to a convenient time under the control of the employer rather than the employee. However, given the fact that marketing of farm products is largely controlled by the demands of purchasers (livestock yards, meat packers, grain or milk processors, etc., or as a result of economy of scale or other bona fide business reasons), an employee who is paid with an agricultural commodity will occasionally be unable to demonstrate independent marketing by selling in transactions that are separate from those of the employer. Similarly, a farm worker may encounter problems in disposing of small quantities of livestock and grain as well as milk and other items. Accordingly, the worker must necessarily associate his or her commodities with those of the farm employer to facilitate the sale of those commodities. Such a unified arrangement creates a rebuttable presumption that suggests cash equivalency rather than a bona fide commodity transfer. Taxpayers must be able to demonstrate that there are significant objective reasons for the employee to act in concert with the employer in marketing products.

Exh 4-10 *continued*

In the event an employee sells a commodity in unison or in collaboration with the employer, a single payment (*i.e.*, a check to one payee) is strongly indicative of marketing by the employer and could be fatal to the wage exception. Furthermore, the sale of a commodity by an employee back to the employer should, under no circumstances, be considered a bona fide transfer. A purchase by the employer indicates lack of independence and would be fatal to an attempt to seek exemption.

**c. Employee Assumes the Risk of Gain or Loss.** An employee must assume the risk of loss with respect to both price fluctuation and change in the quality or nature of the commodity from the time the commodity is transferred until the time of sale by the employee. The greater the risks assumed by the employee, the more likely the transaction will be respected.

When the employer agrees to compensate the employee in terms of future commodity production, the greatest risk is assumed when the compensation arrangement is based on a fixed percentage of production. The employee assumes the physical risk in that the yield may be below expectations or the quality may be deficient. The employee is also subject to the risk of price fluctuation as the commodity develops. In this type of payment arrangement, however, the employee may, in fact, be a share farmer with earnings subject to SECA tax.

When the compensation arrangement is based on a fixed quantity of a commodity, the risk of loss is less. The employee is insulated from production risks but remains vulnerable to price fluctuation during the growing season. In addition, some physical risk may be established through delaying the sale of the commodity after receipt.

When the compensation arrangement is based on a fixed dollar value of a commodity, any physical or price fluctuation risk incurred involves holding the commodity after the transfer. This type of arrangement is the most likely to be considered a cash equivalent, due not only to the low-level risk of loss but also to the indication that the transaction was intended to be a substitute for cash.

It is important that the examiner consider whether the employer has somehow indemnified the employee against loss or deterioration or insured replacement of unmarketable commodities resulting from theft, vermin, pestilence, spoilage, death, etc. An obligation of the employer to

Exh 4-10 *continued*

replace lost commodities creates a presumption that the employee has not assumed the benefits and burdens of ownership and that the employer has not relinquished dominion and control over the commodity.

An employee who is compensated based on a percentage of production, e.g., 10 percent of harvested crops or hogs produced, will be presumed to be at risk if the employer does not guarantee replacement or minimum units of production. To this end, the employer will be required to maintain production records to support the basis for the wages paid in kind, e.g., if the employer harvests 10,000 bushels of corn, the employer must show a payment based on the actual yield. Any loss of production during storage must be borne proportionately by the employer and employee. Payments based on a percentage of quantities marketed will be presumed to be equivalent to cash.

d. Employee's Holding Period. Although an employer may pay employees in kind, the length of time between the transfer of the commodity to the employee and its disposition for cash or deferred payment must be scrutinized. The length of time an agricultural commodity is held by an employee can be indicative of the parties' intent. However, there is no bright line test. As discussed in the cash equivalency section below, the longer the period between transfer of the commodity from the employer to the employee and subsequent conversion to cash, the less likely it is that the payment is equivalent to cash. The ultimate impact of a holding period by an employee is to be determined by an objective analysis of all relevant facts and circumstances, including those enumerated herein. For example, a compensation package consisting of only noncash remuneration creates the presumption that the employee must necessarily engage in a proximate cash transaction to provide for basic sustenance. See also the discussion of cash equivalency, *infra*.

While there are no cases relating to holding periods, there is a substantial body of case law involving the federal taxation of transfers by gift. These cases indicate that the donor must clearly and unmistakably divest himself of dominion and control, immediately, absolutely, and irrevocably, for ownership to be transferred. A. Weil v. Commissioner, 82 F.2d 561 (5th Cir. 1936). The employee must have time to exercise dominion and control over the use, enjoyment,



Exh 4–10 *continued*

and disposition of the in-kind payment, free from all employer-imposed constraints. The opportunity to raise, breed, store, pledge, consume, sell, or otherwise utilize a commodity in any manner the employee deems appropriate is evidence of dominion and control.

Transactions in which a commodity is transferred to an employee and subsequently purchased by the employer or a third party as part of a prearranged transaction between the employer and employee or the employer and a third-party purchaser will be considered to be equivalent to cash for employment tax purposes.

**e. Employee Bears Costs Incident to Ownership.** Due to the variety of agricultural products used to compensate employees (fruits, vegetables, grain, livestock, milk, flowers, etc.) and the timing of such payments in the life cycle of the product, the extent of maintenance and management that is required for each type of commodity necessarily depends on the facts and circumstances of each case.

The employee should be responsible for the costs necessary to maintain the commodity after receipt. For grain, this would typically involve storage fees. For livestock, the employee should be responsible for the care, feeding, and management of the animals from the time the payment is made until disposition. When the employee uses the employer's facilities, the arrangement should be at arm's-length. The employee's failure to incur these costs indicates that a bona fide transfer of the commodity did not occur.

Other important considerations are whether the farm employee has the facilities and equipment necessary to maintain the commodity. If not, does the employee rent facilities from the farm employer or a third party, or are these provided to the farm worker at no charge or a token amount as a wage "gross-up"? The latter situation denotes a lack of control by the employee and a failure to bear the burdens of owning the commodity, thereby indicating that the payment was equivalent to cash.

**f. Identification of the In-Kind Payment.** A bona fide payment in kind should involve the transfer of a specific, identified commodity or other product. The method of identifying the in-kind payment will vary according to the type of commodity or product.

Exh 4-10 *continued*

**Livestock.** Hogs, cattle, and other livestock should be tagged, marked, branded, or segregated into separate pens at the time the commodity is transferred to the employee, and the transfer should be documented. Documentation should include a bill of sale referring to specific animals or groups of animals. The document should describe the animals with specificity, stating the type of livestock and the grade or quality. A bill of sale indicating a transfer of a specified number of pounds of slaughter cattle or hogs, for example, has not described the cattle with adequate specificity. Under this type of arrangement, not only would the employee fail to exercise dominion and control over specific animals, but the transaction would be equivalent to cash.

**Other Farm Products.** Farm products such as corn, wheat, soybeans, fruits, vegetables, and milk are fungible; that is, any unit of these commodities is indistinguishable from any other unit of a like grade or quality. Appropriate documentation of an in-kind payment in these types of commodities should also serve to identify the in-kind payment.

The documents evidencing the transfer of fungible farm products should identify the nature, grade, and quality of the commodities used for in-kind payment. They should also specify the location of the commodities and the method by which the employee's commodity will be separated from that which remains the property of the farm operator. The method of identification and separation will vary based on the type of commodity and the existing storage facilities. The greater the evidence of specific identification, the more likely the in-kind payment will be respected for employment tax purposes. Thus, for example, evidence that the fungible commodity payment was immediately transferred from the employer's facilities to a facility used exclusively for the storage of the employee's products presents the strongest case for a bona fide transfer. When commercial storage, such as a grain elevator, is used, the elevator operator must maintain a separate accounting for the employee's grain.

## 2. *Cash Equivalency*

The second prong of the "substance over form" analysis focusses on whether the in-kind payment is equivalent to cash. Several aspects of this analysis have been alluded to above in the discussions of documentation and the length of time the commodity is held by the employee.

Exh 4-10 *continued*

Any agreement as to a specific dollar quantity of commodities, establishing a quantity of the commodity used for payment at the time of sale, will be considered to be an agreement for the payment of cash. Thus, the payment will not be excepted from "wages" for employment tax purposes.

Cash advances made to employees by an employer that are secured by a commodity or satisfied upon the sale of a commodity are considered to be cash wages. Similarly, the employer may not pay wages in kind with the intent of guaranteeing a cash equivalent, *e.g.*, "... the employee is guaranteed to be paid \$5,000 in the form of number 2 yellow corn on the date the corn is sold to the elevator... ." An agreed upon cash payment that is subsequently converted to a commodity is also considered to be equivalent to cash.

In addition, a payment made in documents that are readily negotiable are considered to be equivalent to cash. In Rev. Rul. 79-207, 1979-2 C.B. 351, a company paid its farm employees in commodity storage receipts rather than cash to avoid FICA taxes. The company immediately redeemed the employees' receipts for cash. The value of the storage receipts was equal to the amount that the employee would otherwise receive in cash. The ruling concludes that the cash value of the commodity storage receipts paid to the farm employees is, in economic reality, a payment in cash. Thus, it is not excepted from wages under section 3121(a)(8)(A) of the Code.

Although relevant to the dominion and control analysis, *supra*, the length of time between payment in commodities and the disposition of the commodity is also reflective of the parties' intent as to cash equivalency. Transactions in which an employer makes an in-kind payment and then immediately sells the commodity for cash payable to the employee will be scrutinized. The same holds true for transactions in which the employer acts as an agent for the employee in obtaining cash for the employee. Payments in the form of marketable commodities that are bought back from the employee by the employer or a party related to or controlled by the employer are equivalent to cash.

An employer that pays an employee in kind, knowing that an immediate cash conversion will occur, will be liable for employment tax on the payment of those wages. In reviewing this type of arrangement, the economic reality of the transaction must be analyzed to determine

Exh 4-10 *continued*

whether the employer is simply paying cash indirectly rather than directly. An example of when the arrangement should be questioned is when the in-kind compensation is an employee's only source of income for his or her agricultural labor. It would be necessary for the employee to immediately convert the payment to cash to pay for life's necessities. Again, the length of time the commodity is held is relevant to this inquiry.

Payments under a deferred payment contract will, under almost all circumstances, be considered to be equivalent to cash because the sale of the underlying commodity has already occurred. Lastly, Generic Commodity Certificates<sup>2</sup> will be considered to be equivalent to cash because the employer has never owned the commodity. These certificates merely convey a transferable right to receive commodities.

#### IV. INCOME TAX TREATMENT OF THE PARTIES

##### A. Employer Income and Reporting

Payment of wages in commodities is a disposition of property under section 1001 of the Code. Accordingly, any gain recognized by the employer on a bona fide in-kind payment is includible in the employer's gross income under section 61(a)(3). See Rev. Rul. 69-181, 1969-1 C.B. 196. An income tax deduction is allowable for wages paid if income tax is withheld as required by section 3402 of the Code. Because agricultural wages paid in kind are not subject to withholding under section 3402, the requirement would be met and the employer would be allowed a compensation deduction.

The employer is required to report the fair market value of the in-kind payment as "Wages, Tips, and Other Compensation" in Box 1 of the employee's Form W-2. If the exclusion from wages in section 3121(a)(8)(A) applies, the value of the in-kind payment should not be included in Boxes 3 and 5, Social Security Wages and Medicare Wages.

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<sup>2</sup> Governed by the Agricultural Act of 1949 and its amendments.

Exh 4-10 *continued*

**B. Employee Income and Reporting**

The fair market value of in-kind payments on the date of transfer should be reported by the employee's employer on Form W-2. The employee should report this amount on Form 1040 in the year the payment is received, regardless of whether the property is sold or otherwise disposed of during that year. However, any gain or loss recognized upon the subsequent disposition of the commodity should be reported on the employee's Schedule D. The employee's basis in the commodity would be the fair market value of the commodity on the date of transfer, i.e., the amount reported on the employee's Form W-2.

Assuming the employee is not receiving payment under a sharefarming arrangement, gains from the disposition of commodities received as compensation for services rendered are not necessarily subject to SECA tax. The determination is based upon facts and circumstances and revolves around timing, frequency, and nature of the commodity used to compensate for services. Casual, infrequent dispositions would not be determinative of self-employed status. On the other hand, commodities received that become the basis of agricultural production that are enhanced, maintained, and disposed with regularity in a business-like fashion may well subject the recipient to SECA tax liability. For example, gain on the sale of feeder pigs received as compensation under section 3121(a)(8)(A) that are then placed in production and raised for market on a consistent basis would be subject to SECA tax.

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## CHAPTER 5

### ENTITY ALTERNATIVES

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#### OVERVIEW

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An understanding of this chapter will enable you to:

- Identify the various forms of entities available;
- Determine the applicability for use of each type of entity;
- Identify the attributes which make the decision of choosing between a C corporation or an S corporation often quite difficult; and
- Identify the newest entity alternative—a “Limited Liability Company.”

#### INTRODUCTION

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The selection of an entity that fits a client’s needs is sometimes a very difficult choice. Proprietorships, partnerships, Limited Liability Companies, C corporations and S corporations all have distinct advantages and disadvantages.

This chapter will lay out the advantages and disadvantages of each type of entity. In addition, attributes of each type of entity are summarized in a table for quick reference.

The four major forms of business organization include proprietorships, partnerships, C corporations and S corporations. Limited liability companies will also be discussed. The characteristics and tax consequences of each entity are very distinct and should be considered carefully to determine the most appropriate choice.

*Practice Tip:* In discussing selection of an entity for a farming enterprise, the U.S. Department of Agriculture program payment limit should be considered. Under USDA rules, each agricultural producer is limited to \$50,000 annually in federal subsidies and assistance payments. Thus, a father and son organized as a farming corporation will likely only qualify for one \$50,000 limit. However, as individual proprietors, or operating within a limited partnership, they may each qualify for a separate \$50,000 limit. While these rules are beyond the scope of this discussion, any entity selection or change in agriculture should give consideration to the impact on USDA program payments.

## PROPRIETORSHIP

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Proprietorships are a simplified method of conducting a business. The income or loss from the business operation is reported in the individual's tax return. Self-employment tax is paid on earnings of \$433 or more, and the tax is remitted with the Form 1040 income tax.

**Advantages.** A proprietorship is the least complicated of the four alternatives, since no balance sheet is required on the tax return and assets do not need to be transferred to or from a separate entity. Income is taxed once at the individual level. Double taxation does not occur. Conversion to corporation or partnership form is readily available.

A spouse and child may be employed by the sole proprietor as a means of advantageously passing income to the household. Cash wages paid to a spouse or a child, age 18 and over, are subject to Social Security taxation.

Wages paid in commodities for agricultural labor may be exempt from Social Security taxation (see Chapter 4).

Health insurance and medical reimbursement plans structured as employee benefits for family members can be used to deduct health insurance premiums and non-reimbursed medical bills on Schedule F. A sole proprietor can employ his spouse and offer these fringe benefits. In turn, the spouse elects family coverage so that all health insurance premiums and non-reimbursed medical bills are deductible on Schedule F. See Chapter 4 for a detailed discussion on health insurance and medical reimbursement plans.

Without a health insurance plan as outlined above, 45% of premiums for 1998 (the deduction is slated to rise to 100% by the year 2007) for health care are deductible on Form 1040 in arriving at adjusted gross income for a self-employed proprietor. Section 1014 provides for a basis step-up to fair market value at the time of death for zero-basis inventory and depreciated equipment.

**Disadvantages.** A proprietor has total personal liability. Insurance may be used to mitigate risk somewhat. Personal nonbusiness assets are at risk to creditors.

There is a lack of continuity: The entity is terminated at the will of the proprietor, ownership transfer, or death.

Social Security tax can become a very high cost of operating a business in the proprietorship form. For 1998, an effective rate of 15.3% for a self-employed individual applies on net earnings up to \$68,400 and 2.9% for all earnings over \$68,400. Self-employed taxpayers may deduct one-half of their Social Security tax just as a corporation would in paying the employer's share of Social Security tax [Sec. 164(f)].

Proprietorship farms that require a significant portion of their profit to be retained in the business for capital expansion or debt retirement will incur very high Social Security tax (i.e., to the extent cash is consumed by asset additions or debt principal, it is unavailable for prepaid expenses and tax planning expenditures).

Fringe benefits, such as meals and lodging, are not available. See Chapter 4 for a discussion on meals and lodging.

## **PARTNERSHIP**

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A partnership is an arrangement whereby two or more individuals or entities adopt an agreement to operate a business. A separate tax return is required for a partnership. The income or loss from operations is split between the partners based on a predetermined ratio.

Self-employment tax is paid on net ordinary business income of \$433 or more passed through from a partnership to the individual partner.

**Advantages.** A partnership is less complex than a corporation. Partnerships may terminate and proportionately distribute appreciated assets to partners without gain recognition [Sec. 731(a)].

A partnership can allocate income or deductions disproportionately. Partnership income and loss may be allocated to the partners in a different ratio from the ownership percentage [Sec. 704(a)].

Partnerships may use guaranteed payments to distribute income to partners. A guaranteed payment is a fixed payment made to a partner for services or use of capital. Guaranteed payments are a deductible partnership expense and are treated as part of the recipient partner's share of ordinary income [Sec. 707(c)].

Income is taxed once at the individual level. Double taxation does not occur. Section 1014 provides for a basis step-up to fair market value at the time of death for zero basis inventory and depreciated equipment.

**Disadvantages.** General partners lack a shield against liability. Personal nonbusiness assets are at risk except in the case of a limited partner. A partnership lacks continuity since it may be terminated at the will of the partners, by the death of a majority partner or transfer of material ownership. Social Security tax rates are the same as for individuals. (See preceding discussion on Proprietorships.)

Fringe benefits are generally restricted for the partners; however, medical insurance and reimbursement plans may be deducted by the partnership if a spouse of a partner is employed by the partnership.

See the discussion in Chapter 4 (re: meals and lodging as a fringe benefit) for case authority treating a partner as an employee.

## **LIMITED LIABILITY COMPANY**

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Business owners frequently use separate legal entities for business activities, to protect their non-business assets from the claims of business creditors. Shareholders of corporations are entitled to the protection afforded by corporate limited liability. Most states have authorized the formation of Limited Liability Companies, or LLCs.



LLCs are neither a traditional partnership nor a traditional corporation, but rather blend characteristics of each form.

Effective January 1, 1997, the IRS issued final regulations, known as "check-the-box" regs, essentially guaranteeing proprietorship or partnership status to LLCs. Under the default rules of the regulations, a newly formed domestic entity with at least two members is automatically classified as a partnership, while a one-member LLC (in those states where permitted) is treated as a proprietorship for tax purposes. Also, new IRS Form 8832, Entity Classification Election, is provided for those entities which do not desire the default classification [IRS Ann. 97-5, IRB No. 1997-3; Regs. 1.7701].

Because LLC's are relatively new, it is not yet well known how beneficial they may be to farmers.

### **Description of LLCs**

Characteristics of LLCs include the following:

- Ownership interests are not freely transferable;
- The LLC has a stated limit on its duration, such as a 30-year term, or termination upon the death of a member unless all remaining members consent to continue;
- Ownership by "member(s)";
- Individual members have limited liability; and
- Management may be centralized in the hands of designated members.

Before the "check-the-box" regs were issued, LLCs were generally taxed as partnerships, based on various IRS private rulings addressing the statutes in those states authorizing LLCs.

- An early private letter ruling classified a Wyoming LLC as a partnership because it lacked two of the four corporate attributes [PLR 8106082].
- In 1988, the IRS ruled that a Wyoming LLC was taxable as a partnership, despite having centralized management in the form of designated managers. It nevertheless lacked the corporate characteristics of continuity of life and free transferability of interests [Rev. Rul. 88-76, 1988-2 CB 360].
- A 1990 private letter ruling approved partnership tax status to a LLC whose members shared management in proportion to their interests, thus lacking centralized management [PLR 9010027].
- A conversion from limited partnership status into an LLC has been approved as a nontaxable event [PLR 9119029].

What is the self-employment tax status of an LLC member? Proposed regs issued January 16, 1997 treat an LLC member as a limited partner, and thus not subject to SE tax, unless:

- the member has personal liability as a partner for debts of the partnership,
- the member has authority to contract on behalf of the partnership under the statute under which the partnership is organized, or

- the member participates in the partnership business for more than 500 hours during the year.

But if substantially all the LLC's activities involve the performance of services, any individual who provides services is not considered a limited partner exempt from SE tax [Prop. Reg. 1.1402(a)-2].

### **S Corporations and LLCs Compared**

LLCs may include an unlimited number of corporations, partnerships, nonresident aliens, trusts, pension plans, and charitable organizations as members, while S corporations may have no more than 75 (35 before 1997) individuals or estates as shareholders.

Members of an LLC may contribute property to an LLC without recognition of gain. Shareholders of an S corporation may have to recognize a gain if they cannot meet the nonrecognition provisions of Section 351.

LLCs are not restricted to one class of stock as S corporations are.

LLCs may pass through losses and tax-free distributions to the extent of a member's capital contribution plus the member's share of the LLC's debt. S corporation shareholders cannot use their share of the debt within the S corporation to increase their basis.

### **Similarities Between LLCs and Partnerships**

LLCs, like partnerships, have the ability to make special allocations of tax attributes. LLC liabilities are nonrecourse (unless personally guaranteed), placing members of the LLC in a similar position to limited partners. LLCs and partnerships must continue to meet minimum ownership percentage and capital account balance requirements [Rev. Proc. 89-12, 1989-1 CB 798]. General partners (or managing members in the case of an LLC) must have a 1% share of income, deductions and credits. Also, they must maintain a minimum capital account balance of the lesser of at least 1% of total capital or \$500,000.

### **Limited Liability Partnerships (LLPs)**

A Limited Liability Partnership is taxed as a general partnership, but has a partial liability shield. The LLP status is based on amendments to state partnership statutes. Individual state statutes should be reviewed for current state law (if any) relating to LLPs.

**Liability Protection.** The LLP shield relates only to delegated liability, derived from an obligation of the partnership. The shield does not protect the partner from liability on account of his or her own actions.

**Annual Election Required.** The liability shield is formed when the partnership files an annual registration with the office designated by statute. The annual filing fee varies by state. The registration must be renewed annually to retain the liability shield.

**Farm Operations and LLPs.** State law should be reviewed to determine if farm operations qualify under the LLP statute.

### Conclusion

LLCs will generally qualify as partnerships for federal taxation. The IRS's "check-the-box" regulations allow taxpayers to choose whether they want their LLC to be taxed as a partnership.

Caution is necessary since uncertainty remains as to how the states will handle the LLCs. If, for example, a Wyoming LLC does business in both Wyoming and another state, how will the other state tax this income? A careful review of the particular state laws will be necessary before any further consideration is made to form an LLC.

## C CORPORATION

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A corporation is a separate legal entity formed to operate a business.

Corporations must comply with state governing statutes and file a tax return. For a C corporation, income is taxed within the corporate return. Corporate income is not subject to self-employment tax; rather, wages paid to employees are subject to Social Security tax.

**Advantages.** Present federal income tax rates for corporations at lower taxable income levels are lower than individual federal income tax rates (joint status).

### 1998 Corporate Income Rates: Tax

<u>Taxable Income</u>	<u>Federal Tax Rate</u>
\$ 0 – \$ 50,000	15%
\$ 50,001 – \$ 75,000	25%
\$ 75,001 – \$100,000	34%
\$100,001 – \$335,000	39%
\$335,001 – \$10,000,000	34%
\$10,000,001 – \$15,000,000	35%
\$15,000,001 – \$18,333,334	38%
Over \$18,333,334	35%

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The 1998 Individual Income Tax Rates—Joint Status are:

<u>Taxable Income</u>	<u>Federal Tax Rate</u>
\$ 0 – \$42,350	15%
\$ 42,351 – \$102,300	28%
\$102,301 – \$155,950	31%
\$155,951 – \$278,450	36%
Over \$278,450	39.6%

**Comparison of Rates.** The benefit of corporate income tax rates decreases at the \$50,000 taxable income level and disappears at the \$75,000 taxable income level. The potential income tax savings below the \$50,000 taxable income level is about \$995, assuming that \$50,000 of taxable income can be split equally (\$25,000 to the individual tax return and \$25,000 to the corporate return).

**Illustration of Tax at \$50,000 of Taxable Income**

Corporation/Individual	\$7,500
Individual	<u>8,495</u>
Difference	<u>\$ 995</u>

Because of the more highly graduated rates for a single person, this tax savings potential increases for a non-married business operator.

**Social Security Tax.** An incorporated business pays Social Security taxes on wages drawn from the corporation. The rate and maximum level are the same as those of a self-employed individual.

*Practice Tip:* Since the Social Security tax rates and bases on self-employed income and corporate employee wages are similar, one might initially come to the conclusion that it is immaterial whether a business is incorporated or not; however, often the owner of a business can withdraw dollars from a corporation in a form in which Social Security tax does not need to be paid (i.e. rent, interest, wages in commodity, etc.).

On the other hand, if no cash is drawn out through rent or interest and some profits are left in the corporation, Social Security tax may also be less than for the proprietorship or partnership entity.

**Example 5-1**

A farming proprietorship has a \$50,000 net profit. The farmer would pay \$7,065 of Social Security tax ( $\$50,000 \times 15.3\% \times 92.35\%$ ).

Realizing that about \$30,000 of annual income is retained in the business and only \$20,000 withdrawn for personal use, the farmer incorporates and draws a \$20,000 gross salary from the corporation.

A \$20,000 salary out of the corporation would result in Social Security taxes in the amount of \$3,060 ( $\$20,000 \times 15.3\%$ ).

*Practice Tip:* Beware of the cost connected with Social Security tax savings in the form of lower Social Security benefits at retirement. The level of benefits depends on a person's age, past earnings history and the direction of future government legislation. Present Social Security formulas are based on "average indexed annual earnings" and give significantly more benefit to the first dollars contributed to the Social Security system on an annual basis.

For example, the current retirement benefit formula is as follows:

<u>Average Indexed Annual Earnings</u>	<u>Benefit</u>
First \$5,724	90%
\$5,724 – \$34,500	32%
Over \$34,500	15%

(See Chapter 7 for a further discussion on Social Security retirement planning.)

### **Corporate Fringe Benefits: Retirement Plans**

See Chapter 7 for a discussion on retirement plans.

**Group Term Life Insurance.** A corporation may provide group term life insurance to employees on a nondiscriminatory basis [Sec. 79]. An employee must include in income the cost of life insurance provided by his employer to the extent coverage exceeds \$50,000 of life insurance [Sec. 264(a)(4)].

**Medical Reimbursement Plans/Health Insurance Plans.** Medical reimbursement and health insurance plans can also be established [Secs. 105 and 106]. These plans save tax dollars since the deductions for expenses are not limited to a percentage of gross income as they are when an individual itemizes deductions on his personal tax return. Also, for medical insurance, 100% is deductible by the corporation vs. 45% in 1998 (the deduction is slated to rise to 100% by 2007) on the personal tax return for the self-employed farmer.

To some extent, the corporate advantage of this group of fringes can be diminished. A nonincorporated entity can establish similar plans assuming it has employees, and often spouses and children can be paid as employees if they are substantially involved in the business. (See Chapter 4.)

**Meals and Lodging Furnished for the Convenience of the Employer.** The value of any meals or lodging furnished to an employee, his spouse, or any of his dependents by his employer is not included in taxable gross income if the meals and lodging are provided on the business premises for the employer's convenience and as a condition of employment [Sec. 119].

Corporations may deduct meals and lodging where they can establish that sufficient business reasons exist for requiring the presence of employees, such that meals and lodging would be normally required as a condition of employment [Sec. 162].

This benefit is most often applied to farm corporations where the employees are required to live on the corporate premises to care for grain and livestock.

Only 50% of meals and entertainment expenses are deductible. [Sec. 274(n)(1)].

See Chapter 4 for a further discussion in this area.

### **Other Corporate Advantages**

Corporations have limited liability. Only corporate assets are at risk unless personal guarantees of debt or liabilities are in effect or a stockholder is named individually in a law suit because of personal involvement.

C corporations have available several estate-reduction techniques.

- Corporate stock allows ease of transferability, with the ability to reduce estate ownership without loss of control.
- Gifts of stock can be enhanced through minority discounts; however, the Section 2701-2704 estate freeze rules can present difficult barriers to transfers involving multiple classes of securities.
- Corporations do not terminate upon the death of a stockholder.

C corporations can adopt a fiscal year end other than December 31. Generally, a corporation should adopt a year end that ends just before the busy season begins or inventories are lowest. For example, a C corporation which normally sells its grain in October may choose an August or September year end. By doing so, the income is not taxed until almost a year later.

On the other hand, there are advantages to stockholders of a corporation which chooses a January or February year end: Bonuses paid in the last month of the corporate year are paid to the individual in the first few months of their tax year.

A corporation is allowed a deduction from gross income for dividends (excluding patronage dividends) received from domestic corporations which are subject to income tax. The deduction is computed as:

- 70% of dividends received from corporations owned less than 20% by the recipient corporation;
- 80% of dividends received from a 20%-or-more owned corporation; or
- 100% of dividends received from members of an affiliated group (normally, 80% or more ownership) [Sec. 243(a)].

### Disadvantages of C Corporations

**Liabilities to Corporation in Excess of Basis at Formation.** As a general rule, transfer of liabilities by the incorporator to a corporation will not result in the recognition of gain [Sec. 357(a)]. Accordingly, an incorporator may safely transfer both assets and liabilities to a newly-formed corporation, without the liabilities being considered boot to the incorporator.

However, if the corporation assumes liabilities of an incorporator which are in excess of the adjusted tax basis of the assets transferred by the incorporator, the excess is recognized as taxable gain to the incorporator [Sec. 357(c)]. This test is applied on a stockholder-by-stockholder basis; each stockholder's basis in assets transferred is compared to liabilities transferred to determine if an excess exists. Further, the computation is made by aggregating *all* assets transferred against liabilities transferred per stockholder to determine if an excess exists [Reg. Sec. 1.357-2(a)].

#### Example 5-2

George, a farm proprietor who is in the process of incorporating, will be transferring a livestock barn which has a mortgage (\$80,000), but a current adjusted tax basis of only \$50,000 to the corporation.

George will also be transferring debt-free machinery with an adjusted tax basis of \$35,000.

Because the aggregate basis of assets transferred by George (\$85,000) exceeds the debt transferred, no gain recognition occurs.

*Practice Tip:* The problem of Section 357(c) excess liabilities is quite common in the farm corporation situation. Many of the assets transferred by cash-basis farmers to the corporation have no tax basis, even though they have substantial market value (raised grain, raised livestock, previously expensed supplies, rapidly depreciated special purpose structures).

Further, many farmers have a very low tax basis in the farmland, but have often added mortgages or secondary debt against this property, so that the liabilities exceed tax basis. It is imperative that an Opening Corporate Balance Sheet be drafted and the identity and tax basis of the assets to be transferred to the corporation be determined in advance of the actual incorporation.

**Unrelated Liabilities.** If the assumption of liabilities by the corporation had a purpose to avoid federal income tax *or* lacked a bona fide business purpose, then the liabilities assumed by the corporation are considered boot to the incorporator [Sec. 357(b)].

If Section 357(b) applies due to tax avoidance or lack of valid business purpose with respect to any single liability, then the *total* of liabilities assumed by the corporation is boot to the incorporator, not merely the excess over basis.

*Practice Tip:* When selecting the liabilities to be transferred to the newly formed corporation, the tests of Section 357(b) must be kept in mind.

The liabilities should have a direct relationship to either the farming business as a whole (working capital loans) or to specific farm assets being transferred to the corporation (land contracts or mortgages, or notes on machinery).

Timing of creation of the liabilities can be a strong indication of the business purpose; liabilities created shortly before incorporation and then transferred to the corporation will be especially subject to IRS scrutiny in the event of an audit [*Weaver v. Comm.*, 32 TC 411, 1959; *Thompson v. Campbell*, 64-2 USTC 9659].

### Example 5-3

John Harrison borrowed \$20,000 from banks prior to formation of his farm corporation, with the proceeds used to make personal loans to his son-in-law.

John subsequently incorporated his farming operation and transferred this \$20,000 of bank debt to the corporation.

The liabilities lacked a relationship to the business, and triggered boot to John upon formation of the corporation under Section 357(b). The Tax Court held that these were liabilities lacking a relationship to the business within the meaning of Section 357(b), and accordingly triggered boot upon formation [*John M. Harrison*, 1981 TC Memo 211].

**Additional Administrative Costs.** Corporations are more complex than proprietorships and partnerships, and the following may add to the cost of maintaining a corporation:

- Drafting formation documents;
- Annual minutes must be completed;
- Balance sheet requirement and a separate tax return;
- Separate checking account must be maintained;
- Professional advisory and related fees; and
- Accounting and legal fees relating to incorporation (organization costs must be capitalized and amortized over a period of not less than 60 months) [Sec. 248].

Payroll reporting requirements affect corporations more often than proprietorships and partnerships. Shareholders cannot take a draw as for proprietorships and partnerships. Rather, payments to shareholders for compensation are considered wages. Cash wages paid by a corporation to a child of a shareholder are subject to Social Security taxation whether or not the child is under 18.



Farm corporations normally would exceed the federal unemployment limits (\$20,000 or more of cash wages in a quarter) sooner than proprietorships or partnerships due to wages paid to shareholders. Wages paid in commodities do not count for this test.

Workers' compensation may be required by some states. However, officers and/or family members are generally exempt from coverage.

**Liquidation.** The possibility of double taxation is a threat if assets cannot be withdrawn in the nature of a deductible expense (e.g., salary, rent). A liquidating dividend is nondeductible to the corporation and taxable income to the stockholder.

A corporation must recognize gain or loss on property which is distributed to its shareholders. The gain or loss is equal to the fair market value (FMV) of the assets on the date of distribution less their tax basis [Sec. 336(a)].

#### **Example 5-4**

ABC Farms, Inc. has one shareholder, Harold. ABC is liquidated and distributes one asset, 100 acres of land, with the land's FMV at \$120,000 while its tax basis to the corporation is only \$50,000.

ABC must pay tax on a gain of \$70,000.

Harold must pay tax on the difference between the land's FMV and his tax basis in his stock of ABC.

#### **Other Miscellaneous Taxes**

Other miscellaneous taxes include:

- The Accumulated Earnings Tax, which applies to C corporations, is assessed on corporations that accumulate earnings instead of distributing the earnings to shareholders. The tax is equal to 39.6% of the accumulated taxable income [Secs. 531-537].
- The Personal Holding Company (PHC) tax, which is assessed on C corporations that are closely held and have the majority of their gross receipts (60% of adjusted ordinary income) from portfolio sources such as interest, dividends and royalties. The tax is 39.6% of undistributed PHC income for tax years beginning on or after January 1, 1993 [Secs. 541-547].
- The Corporate Alternative Minimum Tax (AMT), which applies to C corporations and is equal to the tentative minimum tax over the regular tax. The corporate AMT rate is 20%. The corporate AMT is computed on regular taxable income adjusted for tax preferences and adjustments, reduced by a \$40,000 exemption [Secs. 55-59]. The AMT has been repealed for small business corporations (defined in IRC Sec. 55 (e)) for taxable years beginning after December 31, 1997.

## S CORPORATION

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In general, an S corporation does not pay income tax. Instead, similar to a partnership, the corporation's income and expenses are divided among and passed through to its stockholders in proportion to their stock ownership. These stockholders report the income and expenses on their personal income tax returns.

The election for S corporation status is made on Form 2553. Qualifying S corporations cannot have more than 75 shareholders (35 before 1997) or more than one class of stock.

### Advantages of S Corporation Status

**Losses Deductible.** Losses of an S corporation are deductible on the shareholder's tax return. Losses are deductible only to the extent a shareholder has basis in the stock or loans made to the corporation.

**No Special Taxes.** Special taxes such as corporate alternative minimum, PHC and accumulated earnings taxes do not apply to S corporations.

**Double Tax Avoided.** As with partnerships and proprietorships, double taxation of earnings is avoided, although there may be a corporate level tax on distribution of appreciated assets.

**Compensation Not a Problem.** Unreasonable compensation is a minimal income tax issue for S corporations where the Schedule K-1 income flows to the same personal returns as salary income.

**Social Security Tax.** Same advantages as for a C corporation (see preceding discussion).

**Shareholders Limit Their Personal Liability.** Only corporate assets are at risk unless personal guarantees of corporate loans are in effect or a shareholder is named individually in a lawsuit because of personal involvement.

### Disadvantages of S Corporation Status

**Tax With No Cash.** If the corporation retains profits for expansion or debt retirement, the stockholders will be taxed on the profits without receiving cash from the corporation.

**Unavailable Fringe Benefits.** Fringe benefits such as medical plans and employer-provided meals/lodging plans are not available to stockholders owning more than 2% of the corporation's stock and their family members [Sec. 1372(a)].

**Calendar Year Required.** In most cases, S corporations must have a December 31 year-end, unless a Section 444 election is made.

**No Income Splitting.** S corporations do not offer the benefits of income splitting between C corporations and individuals since the corporate income flows through to the shareholder tax

returns. However, shares of stock can be given to children of the shareholder to move income to the children's tax returns. Unearned income in excess of \$1,400 (1998 level) of a child under age 14 is taxed at the parents' rates [Sec. 1(i)].

**Consistent Allocations.** Income, deductions and credits must be allocated consistently to shareholders based on stock ownership. Special allocations are not available as they are for partnerships.

**Deduction Not Available.** The corporate dividends-received deduction is not available to S corporations.

**Insurance Required.** Workers' compensation may be required by some states. However, officers and/or family members may be exempt from coverage.

**Gains on Liquidation.** Upon liquidation of an S corporation, unlike a partnership with proportionate distributions, gain may be triggered at the corporate level on distribution of appreciated assets.

**Salary Attacked.** S corporations are increasingly being attacked by the IRS for unreasonably low salaries to stockholders, with the IRS attempting to recharacterize S distributions as FICA wages.

## COMPARISON OF S CORPORATIONS AND C CORPORATIONS

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### Introduction

Tax practitioners are continually faced with the question of whether a newly formed farm corporation should be an S corporation or a C corporation; or should an existing farm corporation elect S status or revoke its S election. Following is a summary of some of the major factors which should be considered in dealing with these questions as they relate to farm corporations.

### Advantages of S Corporations Compared to C Corporations

S corporations avoid double taxation associated with C corporations. A C corporation is taxed on its annual earnings which are again taxed to the shareholder upon sale or liquidation. Appreciated assets trigger corporate tax upon sale or distribution at the C corporation level and again to the shareholder upon liquidation. IRS audit adjustments to C corporation expenses often result in dividend treatment to shareholder (for example, personal consumption expenses).

Depending upon income levels, S corporations may achieve taxation of income at lower individual rates. Losses, deductions, and credits are passed through to the individual returns of S corporation shareholders (to the extent of basis). S corporation shareholders may deduct interest expense incurred by the shareholder to acquire the stock of the S corporation. This interest is treated as fully deductible business interest if the shareholder materially participates. For the acquisition of C corporation stock, this interest is considered investment interest [IRS Notice 89-35, 1989-1 CB 675].

Income may be split with other family members through the ownership of stock. However, beware of Section 1366(e), which requires adequate compensation to shareholders of family corporations who provide services or furnish capital to the corporation.

The accumulated earnings tax is not applicable to S corporations.

The risk of an unreasonable compensation attack for excessively high salaries is not applicable to S corporations.

The personal holding company tax can be avoided. However, beware of the excess passive gross-receipts tax for S corporations with prior C corporation earnings and profits.

Social Security tax can be minimized by holding corporate salaries below the FICA maximum and increasing S distributions. However, the IRS can recharacterize distributions from an S corporation as salaries subject to payroll taxes if distributions are in lieu of adequate salary.

The 35% flat tax imposed on personal service corporations can be avoided (but note that an existing personal service corporation considering an S election faces a substantial tax risk from the Section 1374 built-in gains tax on such items as accounts receivable – see disadvantages below).

Corporate alternative minimum tax is not applicable to S corporations.

### **Disadvantages of S Corporations Compared to C Corporations**

**Built-in Gains Tax.** To discourage a C corporation from electing S corporation status to avoid double taxation upon liquidation, a “built-in gains tax” was enacted by the Tax Reform Act of 1986. The built-in gains tax applies to C corporations that filed an S election after December 31, 1986. Certain “qualified corporations” had until December 31, 1989 to make the election and avoid portions of the built-in gains tax rules.

The built-in gains tax applies to both ordinary income and capital gains. The corporation must pay the built-in gains tax when it recognizes a built-in gain on the disposition of assets on hand at the date the S election became effective.

The maximum built-in gain that is taxed is the “net unrealized built-in gain” which is the excess of the aggregate fair market value over the aggregate adjusted basis of all assets on hand as of the first day on which the S election is effective [Sec. 1374(d)(1)].

The tax on a built-in gain is equal to the highest tax rate applicable to a corporation in the year the gain is recognized (currently 35%).

The built-in gain provisions apply during a 10-year period beginning with the first day of the first year for which the S election was effective [Sec. 1374(d)(7)].

Corporations with high risk for the built-in gains tax include:

- Cash method farmers with appreciated inventories (i.e., raised crops with zero basis);  
and

- Taxpayers with substantially appreciated Section 1231 assets (i.e., fully depreciated farm equipment and structures) or substantially appreciated land.

**At-Risk Limitations.** The deduction of pass-through losses at the shareholder level may be limited by:

- Insufficient tax basis in stock;
- Insufficient tax basis in direct third-party loans to the corporation. (Note: There is no basis for a stockholder's guarantee of third-party loans to the corporation); and
- Application of the Section 465 at-risk rules (see Chapter 3).

**Passive Loss Limitations.** Pass-through losses and credits at the shareholder level may be limited because of the Section 469 passive activity loss rules in the event of:

- Lack of material participation by the shareholder [Sec. 469(h)]; or
- Rental activity limitations [Sec. 469(i)].

*Note:* C corporations which are personal service corporations are also fully subject to the passive activity loss rules. Closely held C corporations (corporations having more than 50% in value of stock owned directly or indirectly by not more than five individuals) may use passive losses to shelter active business income but not portfolio income.

**Eligibility Limitations.** S corporation eligibility criteria may be a barrier or result in unintended termination. The eligibility criteria are:

- 75-shareholder limit (35 shareholders before 1997);
- Single class of stock; and
- Corporations, partnerships, nonresident aliens, or certain types of trusts cannot be shareholders.

Fringe benefits are limited for shareholders owning directly or indirectly more than 2% of the stock.

S corporations must use a calendar year unless one of the following exceptions is met:

- "Business purpose" application to adopt or retain a fiscal year [Rev. Proc. 87-32, 1987-2 CB 396]; or
- Election of fiscal year under Section 444.

Use of the 15% tax bracket available to C corporations on the first \$50,000 of taxable income is lost.

Carryovers of NOLs and business credits from previous years when the corporation was a C corporation are deferred under Section 1371(b) and may expire unused.

The corporate dividends-received deduction is not available to S corporations.

Because it may not always be possible to pay profits out to the shareholders, taxation of income to shareholders may not be consistent with cash flow to shareholders.

The accumulated adjustments account (AAA) and basis rules are complex with respect to S corporation distributions if the corporation has accumulated earnings and profits (AE&P).

Corporate-level tax is imposed on S corporations with more than 25% of gross receipts from passive investment income and C corporation AE&P. The S corporation can lose its status if this test is not met for three years [Sec. 1375].

### **INCORPORATION CHECKLISTS**

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In the following exhibit are checklists of advantages and disadvantages of incorporation, farm or non-farm. Each item should be reviewed with clients considering possible incorporation, making sure they have a complete understanding of all items.

**EXHIBIT 5-1****INCORPORATION CHECKLISTS****Introduction:**

The following checklist is offered as a guide in reviewing the potential for and establishing a corporation for clients.

The accountant may use whatever information is deemed appropriate; however, it is recommended that the checklist be completed for every corporation and retained in the corporate file.

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**INITIAL CHECKLIST OF DUTIES AND ACCOUNTANT RESPONSIBILITIES**

1. Discuss difference between an S corporation and a C corporation.
2. Review advantages and disadvantages of incorporation with client.
3. Complete Corporate Information Sheet.
4. Be sure provisions under IRC Section 351 and 357 have been reviewed.
5. Review Client Responsibilities Checklist. Give copy to client.
6. Review and follow Checklist of Items to Exchange With Attorney.
7. Draft required application for I.D. #'s.
  - a. SS-4 (Tele-tin)
  - b. MBA—w/h (if required)
  - c. MBA—sales tax (if required)
  - d. MN—unemployment (if required)
8. Instruct client on payroll tax requirements.
  - a. Rates and deposit requirements on FICA.
  - b. FWHT/MWHT to be deducted? Give withholding booklets and Forms W-4 and I-9 to client.
  - c. Distribute Employee's earnings records & instructions to client.
  - d. Transfer any previous unemployment rate.
9. Secure data for and draft Opening Corporate Balance Sheet.
 

Blank compilation letter.  
Sample balance sheet.
10. Instruct client on bookkeeping requirements.
  - a. Who will do bookkeeping? \_\_\_\_\_ Client  
\_\_\_\_\_ Accountant
  - b. Will a financial statement be required?  
(i.e. at year end for bank, etc.)  
\_\_\_\_\_ Yes \_\_\_\_\_ No



11. Initial corporate tax return items.
  - a. Section 351 disclosure statement.
  - b. Organization expense election.
  - c. For new businesses, start-up expense elections.
12. Complete engagement letter.

**CHECKLIST OF ADVANTAGES OF  
INCORPORATION DISCUSSED WITH THE CLIENT**

INITIALS \_\_\_\_\_

DATE \_\_\_\_\_

ADVANTAGES

## I. Income Tax Savings

## A. C Corporations

1. Tax brackets (beware of 35% PSC rate)
2. Fringe benefits
  - a. Medical insurance - note: can discriminate
  - b. Medical reimbursement - note: cannot discriminate
  - c. Group term life insurance

FARM

3. Meals & lodging
4. Pension and profit sharing plans
5. New tax elections/accounting methods
6. Lease of house from corp. after sale
7. Social security tax? (Plan carefully)

FARM

## B. S Corporations

1. Social security tax? (Plan carefully)
2. New tax/accounting methods

## II. Estate Planning

- A. Easier transferability from senior generation to successor family members or other potential part owners (watch IRC Sec. 2071)
- B. Life insurance - use to fund purchase of stock (be careful of ownership)
- FARM C. Can preserve § 2032A "special use" land valuation
- D. Can preserve § 6166, deferred estate tax payment privilege

## III. Miscellaneous

- A. Limited liability (minimal advantage for most closely held corporations)
- B. Better records (assets & liabilities - double entry system)

IV. Social Security

- A. May limit tax due to wages being lower than total profits
- B. Request earnings and benefit statement from social security
- C. Fully deductible by corporation (similar to 50% SE deduction)
- FARM D. Decrease social security tax by limiting wages and using "payments-in-kind".

Comments:

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Notes on follow-up possibilities:

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**CHECKLIST OF DISADVANTAGES OF  
INCORPORATION DISCUSSED WITH THE CLIENT**

INITIALS \_\_\_\_\_  
DATE \_\_\_\_\_

**DISADVANTAGES**

**I. Income Tax**

- A. Potential for "dividend" issues & double taxation
  - 1. Taxation at market values in event of liquidation
  - 2. Personal benefit areas
- B. Must plan for personal income tax from January 1 to date of incorporation (also give consideration to corporate level income)
- FARM** C. For farmers tax payment deferred privilege lost - quarterly tax estimates required
- D. ACE and AMT for C corporations
- E. Watch for multiple corporations (brother-sister etc.)
- F. Minnesota tax rates:
  - 1. Higher than individual
  - 2. New filing fee

**II. Social Security Tax & Payroll Tax**

- A. Salaries to owner's children no longer exempt from social security
- B. Lower social security base could reduce retirement benefits
- C. May be subject to unemployment taxes (both Federal 940 and state) (Note ag and non-ag limits are different)

**III. Increased Paperwork**

- A. Additional income tax return
- B. Increased legal fees - organization and annual meetings
- C. Payroll tax returns
- D. Additional "state report" filings

**IV. Estate & Retirement**

- A. Cannot transfer specific items to specific individuals without options, spin-off's, etc.
- B. Limited income to retired individual if land is in corporation (try to keep land out-plan carefully)

**V. Tax Traps**

- A. Section 351 (be sure 80% control requirement is met)
- B. Section 357 (Excess of liabilities over tax basis of assets-strong potential for farm cash basis taxpayers. If potential draft B/S to test and plan before proceeding.)
- C. Locked in net operating loss and capital losses
- D. Locked in earnings and accumulated earnings penalty tax
- E. Section 179 recapture on assets kept out of corporation and rented (Prorated over recovery period)

**VI. Miscellaneous**

- A. Discuss need for workers' compensation and possible exemption for corporate officers
- FARM** B. Agriculture only-may lose part of homestead benefits if home transferred without up to 320 acres of farmland that homestead applies to

**NEW CORPORATION INFORMATION SHEET**

1. Name of corporation: \_\_\_\_\_
2. Address of corporation: \_\_\_\_\_
3. Date of incorporation: \_\_\_\_\_
4. County of incorporation: \_\_\_\_\_
5. Name, address and social security number of incorporators:
  - a. \_\_\_\_\_
  - b. \_\_\_\_\_
  - c. \_\_\_\_\_
  - d. \_\_\_\_\_
  - e. \_\_\_\_\_

6. Names of Officers & Directors:

President: \_\_\_\_\_  
 Vice-President: \_\_\_\_\_  
 Secretary: \_\_\_\_\_  
 Treasurer: \_\_\_\_\_  
 Directors: \_\_\_\_\_

7. Corporate Stock

- a. Authorized capital: \$ \_\_\_\_\_
- b. Number of shares authorized: \_\_\_\_\_
- c. Number of shares issued: \_\_\_\_\_
- d. Par value of shares: \$ \_\_\_\_\_

8. Stockholders and number of shares issued:

	<u>Name</u>	<u>SS#</u>	<u>Birth- Date</u>	<u>No./Shares</u>	<u>Cert#</u>	<u>Date</u>
a.	_____	_____	_____	_____	_____	_____
b.	_____	_____	_____	_____	_____	_____
c.	_____	_____	_____	_____	_____	_____
d.	_____	_____	_____	_____	_____	_____
e.	_____	_____	_____	_____	_____	_____

9. Name and address of bank: \_\_\_\_\_

10. Fiscal year-end: \_\_\_\_\_

11. Subchapter S corporation election? \_\_\_\_\_  
 (Note - be sure to file within 15th day of third month of tax year)

Indicate who will file election \_\_\_\_\_

12. Stockholders' restrictive agreements (buy-sell):

13. Date business was started: \_\_\_\_\_

14. Number of employees: \_\_\_\_\_

15. Date first wages will be paid: \_\_\_\_\_

16. Average monthly payroll: \$ \_\_\_\_\_

17. Employees and annual compensation: \_\_\_\_\_

_____	\$	_____
_____	\$	_____
_____	\$	_____
_____	\$	_____
_____	\$	_____

18. Attorney's name, address and phone number: \_\_\_\_\_

\_\_\_\_\_

19. Employee residence locations: \_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

20. Tax I.D. #'s

a. Federal tax I.D. # (per Tele-tin) \_\_\_\_\_

b. State tax I.D. # (if applicable) \_\_\_\_\_

21. Corporate charter no. (for MSS-1) \_\_\_\_\_

22. Accounting method info:

a. Basis of accounting for tax purposes \_\_\_\_\_

b. Any special elections required or computations?

1) IRC Section 461 accrual election \_\_\_\_\_

2) IRC Section 351 transfer statement  
(with individual's return) \_\_\_\_\_

3) Organization expense amortization  
election \_\_\_\_\_

4) Start-up expenditures amortization  
election \_\_\_\_\_

5) \_\_\_\_\_

6) \_\_\_\_\_

7) \_\_\_\_\_

**CHECKLIST OF DUTIES****CLIENT RESPONSIBILITIES**

Federal Tax I.D.# \_\_\_\_\_

1. Contact attorney to:
  - a. Approve name
  - b. File articles and forward a copy to accountant
2. Provide information requested by accountant to prepare opening corporate balance sheet and help determine what assets and liabilities will be transferred.
3. Gather information and meet with accountant to do income tax planning prior to incorporation.
4. Set up corporate checking account using new Federal tax identification number.
  - a. Order printed checks (be sure to use approved corporate name).
  - b. Fund the account (this activates the corporation for tax purposes, assuming the Articles of Incorporation have been filed).
5. Transfer title on vehicles, land and contracts (Discuss sales tax exemption - transfer exempt if exchanged for stock).
6. Notify other vendors (in the normal course of business dealings) of the name change and new identification number.
7. Transfer insurance policies on property, vehicle fleet policy, farm liability, and medical/disability (if group contracts are being initiated).
8. Notify creditors of name/legal status and identification number change.
9. Gather information to file any final returns (partnership, etc.).
10. Meet with accountant to set up chart of accounts and bookkeeping/accounting procedures.
11. Know and understand payroll tax withholding, deposit and recordkeeping requirements.



12. Secure any special licenses and permits in corporate name.

Farm corporations:

1. Notify cooperatives to start a new account in the corporate name and identification number (normally don't transfer in existing equity).

**ITEMS TO EXCHANGE WITH ATTORNEY****A. NEED FROM ATTORNEY:**

1. Approved corporate name
2. Date of incorporation (official date per filing with Secretary of State - will need to coordinate with activating corporation)
3. Copies of articles (and by-laws if possible) (Caution: Be sure to advise if corporation intends to apply for a homestead credit. Special language must be inserted in Articles to apply. Attorney may need to check with courthouse before drafting.)
  - a. Number of shares authorized
  - b. Class and par value (if any) of shares authorized
4. Corporate charter number
5. Copies of any final agreements between shareholders and officers of corporation (rental, lease, employment agreements, stockholders' agreements, etc.)

**B. TRANSMIT TO ATTORNEY:**

1. Opening Corporate Balance Sheet
  - a. Clarify types of stock to be issued and number of shares to each stockholder.
  - b. Highlight land to be transferred and to be retained.
  - c. Advise (per balance sheet) of items transferred for exchange agreement.

**C. INFORM/COUNSEL ATTORNEY RE: TAX CONSEQUENCES OF:**

1. Lease of land to corporation
  - a. Suggest non-participating to avoid S.E. tax.
    - (1) Caution on structuring agreement to preserve 2032A and 6166 where in some cases cash rent may be a problem.
    - (2) Caution on portfolio vs. passive income or (loss).
  - b. Increase flexibility, particularly if corporation to hold grain and market at

landlord direction. If individual dies, does not get step-up in estate.

- c. Attorney to do "State Report of Ag. Corp."
2. Buy-Sell Agreement - Good idea even for closely-held family corporations.
    - a. Cross-purchase vs. redemption?
    - b. Insurance funding? - reference in agreement (be careful of ownership to avoid ACE and AMT)
    - c. Should Wills also be revised?
3. Items for Minutes of Board
    - a. Medical expense reimbursement plan?
    - b. Medical insurance plan
    - c. Group disability plan?
    - d. Group term life insurance?
    - e. Resolution regarding reclassification of ordinary and necessary business expenses by governmental authorities (see page 13)
    - f. Employment arrangements:
      - (1) Annual officer compensation (peg a high number)
      - (2) Agriculture
        - (a) Payment in form of commodities?
        - (b) Lodging as a condition of employment?
        - (c) Meals as a condition of employment?

Note that groceries must be prepared into meals by a corporate employee, and both lodging and meals:

- (a) Furnished on the business premises of corporation
- (b) Furnished for convenience of employer (document need to sustain employees on the premises 24 hours/day).
- (c) Employee is required to accept as a condition of employment (See: Harrison, TC Memo 1981-211).

- g. Vehicle use: Require corporation to inform officer of personal use element on vehicles, etc. and to authorize as additional compensation.
  - h. Corporate Resolutions authorizing various bank accounts/borrowing.
  - i. S corporation to be utilized? (Get a copy of election to attorney).
  - j. Fiscal year-end selected?
4. Pension or Profit Sharing Plan?

**RESOLUTION REGARDING RECLASSIFICATION OF ORDINARY AND NECESSARY BUSINESS EXPENSE BY GOVERNMENTAL AUTHORITIES**

WHEREAS, It is the policy of this corporation to authorize its officers to incur travel and other expenses which are deemed advisable, ordinary, and necessary in order to properly perform their duties.

WHEREAS, It has been the policy of this corporation to reimburse certain of the business expenses described above but not to reimburse any personal expenses.

WHEREAS, It is the policy of the corporation, in determining executive compensation, to consider that those business expenses described above which are not reimbursed or paid for by the officers together with their personal expenses shall be borne by them.

WHEREAS, This corporation is aware of the possibility that governmental authorities may differ with it in classifying expenses as ordinary and necessary business expenses or as personal expenses.

NOW THEREFORE BE IT FURTHER RESOLVED, That ultimate classification of its expenses, except compensation, by governmental authorities as ordinary and necessary deductible business expenses or as nondeductible business expenses shall prevail for purposes of executing the corporate policies referred to above.

AND THEREFORE BE IT FURTHER RESOLVED, That travel and such other expenses described above, whether paid to officers or others, which are held to be personal expenses by governmental authorities, shall be considered as additional compensation to the officers involved in order to consistently follow the Corporation's policies, as described above, of providing funds to its officers, directly through reimbursement in the case of certain reimbursable business expenses, and indirectly through compensation in the case of nonreimbursable business and personal expenses.

**IRC SECTION 351 TRANSFER STATEMENT**

\_\_\_\_\_  
\_\_\_\_\_

On \_\_\_\_\_, \_\_\_\_\_, a sole proprietor, transferred substantially all of the assets of his \_\_\_\_\_ operation to \_\_\_\_\_, a newly-formed corporation. A copy of the assets transferred to the corporation is attached to this statement.

The assets of the former proprietorship were transferred to the corporation solely in exchange for the securities of the corporation, pursuant to Section 351. Accordingly, no gain or loss was recognized on the transfer, and the tax basis of the assets in the hands of the proprietor as of \_\_\_\_\_ carries over to become the tax basis of the assets in the hands of the corporation.

**A STATEMENT ATTACHED TO AND MADE PART OF  
CORPORATION INCOME TAX RETURN  
FOR THE TAXABLE YEAR ENDED \_\_\_\_\_ 19\_\_**

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**ELECTION RE: AMORTIZATION OF ORGANIZATION EXPENSE**

In this, its first taxable year, taxpayer incurred \$ \_\_\_\_\_ as organizational expenditures incident to its creation. Under the provisions of Section 248 of Internal Revenue Code and the Regulations thereunder, taxpayer hereby elects to amortize such expenses over the 60-month period commencing with the date of formation, which constitutes the month in which taxpayer began business.

**SECTION 195 ELECTION TO AMORTIZE  
START-UP EXPENDITURES**

\_\_\_\_\_  
\_\_\_\_\_

FORM 1120

**AMORTIZATION OF START-UP EXPENDITURES**

Pursuant to IRC Section 195, \_\_\_\_\_ elects to amortize the following start-up expenditures over 60 months beginning with \_\_\_\_\_, 19\_\_, the month in which the corporation began business. This information is submitted as required:

DESCRIPTION OF EXPENSE	DATE INCURRED	AMOUNT \$
Total start-up costs		\$ _____



## FARM

### MEALS AND LODGING AUTHORIZATION

Sample language for authorization of meals and lodging (to be entered in employment agreement and, with some modification to language, authorized in the minutes of the corporation, with modifications as may be required to fit each client situation).

As a condition of this Employment Agreement, and for the convenience of Employer, Employee agrees to accept meals and lodging provided by Employer and located on the business premise. This provision is an essential requirement of this Employment Agreement and deemed necessary by the Employer for the following reasons:

- (1) It is essential for the health and safety of all livestock that Employee be available to tend to their needs on a 24 hour basis. If Employee finds it necessary to be away from the business premise for an extended period, Employee shall make arrangements for another to be available to tend to the immediate needs of all livestock.
- (2) It is impractical for the tangible assets of Employer to be stored behind lock and key and such items are often exposed to possible theft and/or vandalism. For this reason it is essential that Employee reside on the business premise in order to safeguard Employer's assets.
- (3) Because of the rural setting of Employer's business premise and the distance that said premise is located from the nearest town, an unacceptable amount of the work day would be consumed by travel if Employee did not receive meals on the business premise. Therefore, to minimize non-productive time during the work day, Employee shall accept Employer supplied meals on the business premise.

**PREPARATION CHECKLIST  
OPENING CORPORATE BALANCE SHEET**

Client: \_\_\_\_\_  
Completed by: \_\_\_\_\_

Balance Sheet Date: \_\_\_\_\_  
Date Completed: \_\_\_\_\_

PROCEDURE

Completed by  
or N/A

**PREPARER PROCEDURES**

1. Obtain list of assets and liabilities to be contributed by each shareholder to the corporation. \_\_\_\_\_
2. Determine tax basis of assets and liabilities. \_\_\_\_\_
3. Obtain fair market value of assets and liabilities. \_\_\_\_\_
4. Determine that the liabilities assumed by the corporation do not exceed the tax basis of the assets contributed (must be determined for each shareholder). \_\_\_\_\_
5. Prepare accountants' compilation letter. \_\_\_\_\_
6. Determine the number of copies of the balance sheet required. \_\_\_\_\_

**TECHNICAL REVIEWING PROCEDURES**

1. Review balance sheet for propriety of form and content. \_\_\_\_\_
2. Review the preparer's workpapers to see that they adequately support the balance sheet. \_\_\_\_\_
3. Discuss with the preparer any changes made or required. \_\_\_\_\_
4. Return data to preparer for correction if necessary. \_\_\_\_\_

**SIGNING PROCEDURES**

1. Read the financial statements to determine that they are appropriate in form and free of obvious errors and departures from GAAP. \_\_\_\_\_

**BANK COMPILATION LETTER — TAX BASIS AND MARKET**

September 4, 199X

To the Stockholders and Board of Directors  
Apple Farms, Inc.  
Anycity, MN

We have compiled the accompanying opening corporate statement of assets, liabilities and stockholders' equity – income tax basis and market value of **APPLE FARMS, INC.** as of July 14, 199X, and the related supplementary data in accordance with standards established by the American Institute of Certified Public Accountants. The financial statement has been prepared on the accounting basis used by the company for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

A compilation is limited to presenting in the form of a financial statement and supplementary data information that is the representation of management. We have not audited or reviewed the accompanying statement and supplementary data and, accordingly, do not express an opinion or any other form of assurance on them.

Management has elected to omit substantially all of the disclosures ordinarily included in financial statements. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the Company's assets, liabilities, equity, revenues, expenses, and cash flows. Accordingly, this financial statement is not designed for those who are not informed about such matters.

Management has elected to display the market values of all assets and liabilities on the statement in addition to the income tax basis. Market values are based on the estimates of management.

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**SMITH, BARNES & COMPANY, CHARTERED**  
Certified Public Accountants

SAMPLE STATEMENT OF ASSETS, LIABILITIES, AND SHAREHOLDERS' EQUITY

APPLE FARMS, INC.  
 OPENING CORPORATE STATEMENT OF ASSETS, LIABILITIES AND STOCKHOLDERS' EQUITY --  
 INCOME TAX BASIS AND MARKET VALUE  
 JULY 14, 199X

(See Accountants' Compilation Report)

**ASSETS**

	As transferred by Greg Apple		As transferred by Frank Smith		Total	
	Tax Basis	Market Value	Tax Basis	Market Value	Tax Basis	Market Value
Inventory:						
Soybeans (8,700 bu. \$5.50/bu)	\$ --	\$ 47 850	\$ --	\$ --	\$ --	\$ 47 850
Corn (21,000 bu. \$2.00/bu)	--	42 000	--	--	--	42 000
Market hogs (469 head - all sizes	--	2 488	--	76 291	--	78 779
Prepaid expenses:						
Seed	--	3 000	--	5 000	--	8 000
Diesel fuel	--	500	--	--	--	500
Feed	--	--	--	2 000	--	2 000
Breeding stock (see attached list)	--	--	2 872	9 903	2 872	9 903
Equipment (see attached list)	<u>25 437</u>	<u>103 000</u>	<u>15 500</u>	<u>87 000</u>	<u>40 937</u>	<u>190 000</u>
Total Assets	<u>\$ 25 437</u>	<u>\$198 838</u>	<u>\$ 18 372</u>	<u>\$180 194</u>	<u>\$ 43 809</u>	<u>\$379 032</u>

**LIABILITIES AND STOCKHOLDERS' EQUITY**

	Tax Basis	Market Value	Tax Basis	Market Value	Tax Basis	Market Value
Liabilities:						
Note payable - Any Bank, Any Town, MN	\$ 15 000	\$ 15 000	\$ 5 000	\$ 5 000	\$ 20 000	\$ 20 000
Note payable - John Deere Company	<u>8 644</u>	<u>8 644</u>	--	--	<u>8 644</u>	<u>8 644</u>
Total Liabilities	23 644	23 644	5 000	5 000	28 644	28 644
Stockholders' equity (100,000 shares, no par, voting common stock authorized; 10,000 shares issued and outstanding)	<u>1 793</u>	<u>175 194</u>	<u>13 372</u>	<u>175 194</u>	<u>15 165</u>	<u>350 388</u>
Total Liabilities and Stockholders' Equity	<u>\$ 25 437</u>	<u>\$198 838</u>	<u>\$ 18 372</u>	<u>\$180 194</u>	<u>\$ 43 809</u>	<u>\$379 032</u>

## EXHIBIT 5-2

### COMPARISON OF ENTITY ATTRIBUTES

The following table compares the various attributes of proprietorships, partnerships, C corporations and S corporations.

Attribute	Proprietorship	Partnership	C Corporation	S Corporation
<b>Life of entity</b>	Terminated at will or death of proprietor	Terminated at will or death of a major partner or transfer of material ownership	Indefinite	Indefinite
<b>Transferability of interests</b>	Freely transferable	Typically, subject to partners' approval	Typically, freely transferable; can be restricted through buy-sell agreements	Typically, freely transferable; can be restricted through buy-sell agreements
<b>Liability of owners</b>	Unlimited	General partnership unlimited; partnership: general partner unlimited limited partner limited to investment in partnership	Generally limited to assets in corporation	Generally limited to assets in corporation
<b>Contribution of property</b>	Nontaxable transaction	Generally, a nontaxable transaction assumption of liabilities by partnership may trigger gain recognition	Nontaxable only if transaction meets Sec. 351 requirements; however, liabilities in excess of asset basis may trigger gain per Sec. 357. This could be a potential problem for cash basis farmers.	Nontaxable only if transaction meets Sec. 351 requirements; however, liabilities in excess of asset basis may trigger gain per Sec. 357. This could be a potential problem for cash basis farmers.

<b>Attribute</b>	<b>Proprietorship</b>	<b>Partnership</b>	<b>C Corporation</b>	<b>S Corporation</b>
<b>Taxability of income</b>	Taxable to proprietor	Taxable to partner; special allocations possible	Taxable at corporate level	Taxable at shareholder level based on shares held; no special allocations
<b>Deductibility of losses</b>	Deductible by proprietor	Generally, deductible by partner; special allocations possible; partnership liabilities increase loss deduction basis	Deductible by corporation	Generally, deductible by shareholder; Loss limited to basis in stock and direct loans from shareholders. No special allocations allowed.
<b>Passive losses</b>	May not offset active or portfolio income	May not offset active or portfolio income at partner level	May offset active income but not portfolio income if corporation is closely held; may not offset active or portfolio income of personal service corporation	May not offset active or portfolio income at shareholder level
<b>Required tax year</b>	Must use tax year of proprietor	Generally, must use fiscal year of partners or calendar year unless Sec. 444 election made	May select any fiscal year if not a personal service corporation	Generally, must use calendar year unless natural business year test is met or Sec. 444 election made

<b>Attribute</b>	<b>Proprietorship</b>	<b>Partnership</b>	<b>C Corporation</b>	<b>S Corporation</b>
<b>Medical insurance</b>	45% of premium cost is deductible above-the-line; if a spousal insurance plan is in place, 100% of premium cost is deductible on Schedule F	45% of premium cost is deductible above-the-line if a partner's spouse is an employee of the partnership and an insurance plan is in place, 100% of the premium cost is deductible on Schedule F	100% of premium cost is deductible	45% of premium cost is deductible above-the-line by more than 2% shareholders
<b>Life insurance for employee/owner</b>	Nondeductible	Nondeductible	Premiums for up to \$50,000 of group term life are deductible and not taxable to employee	Nondeductible
<b>Distribution to owner</b>	Nontaxable	Nontaxable to extent of basis in partnership; property nontaxable until sold	Not deductible by corporation; generally, ordinary income to shareholder; appreciated property results in gain recognition to corporation	Nontaxable to extent of basis in stock and loans to corporation; distribution of appreciated property results in gain recognition at S corp. level
<b>Sale of interest: Gain</b>	Capital and/or ordinary	Capital and/or ordinary	Capital	Capital
<b>Loss</b>	Capital and/or ordinary	Generally, capital	Ordinary to extent of Section 1244 stock; otherwise capital loss	Ordinary to extent of Section 1244 stock; otherwise capital loss

<b>Attribute</b>	<b>Proprietorship</b>	<b>Partnership</b>	<b>C Corporation</b>	<b>S Corporation</b>
<b>Liquidating distribution</b>	Nontaxable	Generally, nontaxable; Cash distribution in excess of basis or non-pro rata distribution of Section 751 assets will trigger gain	At corporation level treated as a sale of property; gain to shareholder if FMV exceeds stock basis	At corporation level treated as a sale of property; gain passes through and increases shareholder basis; could trigger built-in gains tax
<b>Social Security (FICA) self-employment tax (SE tax)</b>	SE tax paid on net farm earnings	SE tax paid on partnership earnings	FICA tax paid on wages paid to employee	FICA taxes paid on wages paid to employee



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## **CHAPTER 6**

### **TRANSFER OF THE FARM**

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#### **OVERVIEW**

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An understanding of this chapter will enable you to:

- Identify the advantages of structuring a farm sale to a related party as a bargain sale, rather than an installment sale with future gifts of principal;
- Analyze the tax implications of a predeath installment sale to family members;
- Determine how best to fully utilize the Section 121 principal-residence exclusion;
- Recognize the tax implications of Section 1245 recapture involving farm assets; and
- Identify the situations for which the like-kind exchange rules would be beneficial to farm owners.

#### **INTRODUCTION**

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The transfer of farm assets to related or unrelated parties presents many tax planning alternatives. Practitioners must be aware of the bargain sale rules, the Section 121 exclusion relating to the sale of a principal residence, depreciation recapture rules, and tax-deferred exchange opportunities. For most farmers, the disposition of farm assets at retirement represents the most substantial tax event in their business career, and understanding the interplay of these transactions is essential to guiding the farm client.

This chapter will address these tax planning alternatives.

#### **TRANSFER OF FARM ASSETS TO OTHER FAMILY MEMBERS**

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There can be significant tax advantages in structuring a sale of farm assets to a related party as a bargain sale when future gifts of principal on the sale contract are planned. Property is often transferred between related taxpayers in transactions involving both sale and gift aspects. Structuring a property sale below market value can provide a better tax result to the seller than a sale at market value with gifts of future installment payments on a sale contract.

### **Gifts of Installment Payments Will Trigger Income to the Seller**

If an installment obligation is cancelled or otherwise becomes unenforceable, it is treated as if it were disposed of in a transaction other than a sale or exchange [Sec. 453B(f)(1)]. Gain or loss is the difference between the fair market value of the obligation at the time of disposition and its basis. If the obligor and obligee are related persons, the fair market value of the obligation is treated as not less than its face amount. If a seller forgives a portion of the installments, they will be treated as payments from the buyer to the seller with subsequent gifts back to the buyer.

A bargain sale involves making a gift at the point of sale, often in excess of the \$10,000 annual exclusion. The potential consumption of a portion of the donor's \$625,000 estate tax exemption (\$650,000 for 1999, with yearly increases thereafter) can be limited by:

- Electing gift-splitting if the donor is married.
- Creating multiple donees if the recipient is married or other potential donees exist.
- Having a donor with an estate of less than \$625,000 (or the greater amounts that apply in 1999 and later years).
- Retaining a term certain or temporary income interest in the property (but note that retention of a lifetime income right causes inclusion of the full value of the property in the donor's estate under Section 2036).

The following provision of the 1997 Tax Relief Act should be taken into account in planning for bargain sale transactions. For decedents dying after 1997, Sec. 2033A provides for an estate-tax exclusion for "qualified family-owned business interests"—such as family farms. If the exclusion is elected, the gross estate will not include the lesser of:

- the value of the qualified family-owned business interest, or
- the excess of \$1.3 million over the estate-tax exemption amount (\$625,000 for 1998, increasing yearly thereafter).

The estate tax benefit of the exclusion is subject to recapture if certain events occur within 10 years after the decedent's death, such as a sale of the interest to other than a family member. Note that the exclusion only applies to the estate tax. No comparable exclusion is allowed for the gift tax.

### **Allocating Basis on a Part-sale/Part-gift Transaction**

Regulation Section 1.1001-1(e) allows a taxpayer to allocate the entire basis against the sale portion of a transfer involving a bargain sale element. Since none of the basis needs to be allocated to the gift portion, the effect is to lower the taxable gain exactly by the amount of the bargain portion.

The basis in the hands of the transferee is the greater of the selling price or the seller's basis [Reg. Sec. 1.1015-4(a)].

No loss is sustained on such a transfer if the amount realized is less than the transferor's adjusted basis. This is true whether or not the transferee was related to the seller [Reg. Sec. 1.1001-1(e)].

**Example 6-1**

Bruce Wheeler holds land and a building with an adjusted basis of \$40,000, which he intends to sell to his son, Roger. The property is valued at \$100,000; however, Bruce intends to make gifts of up to half of this value to Roger from time to time.

Bruce does not want to make annual property gifts because of the inconvenience of this, and is also anxious to freeze the valuation against expected appreciation in value by entering into a transaction currently.

**Gift of installment sale contract:**

- If Bruce sells the property to Roger for \$100,000 on an installment contract, gain on sale is calculated as:

Total Sales Price	\$100,000
Property Basis	<u>40,000</u>
Gain Recognized by Bruce	<u>\$ 60,000</u>
Adjusted Basis in hands of Roger	<u>\$100,000</u>

- Bruce has locked in an income tax gain of \$60,000 at the point of sale.
- Either he, his estate or his eventual beneficiaries will pay income tax on this gain under the installment disposition rules or the income in respect of a decedent rules, whether Bruce collects the payments or forgives them as gifts.
- Bruce will not incur a reportable transaction for gift tax purposes if a series of annual gifts are made within the \$10,000 exclusion.

**Bargain sale:**

- If Bruce sells the property to Roger for \$50,000, gain on the sale is calculated as:

Selling Price	\$50,000
Property Basis	<u>40,000</u>
Gain Recognized by Bruce	<u>\$10,000</u>
Adjusted Basis in Roger's hands	<u>\$50,000</u>

- Bruce has made a single gift of \$50,000 as of the time of sale, requiring a reportable gift transaction.

**Bargain sale at loss:**

- Assuming Bruce sells the property for \$30,000, gain is calculated as:

Selling Price	\$30,000
Property Basis	<u>40,000</u>
Gain or Loss Recognized	<u>\$ —</u>
Adjusted Basis in Roger's hands	\$40,000

*Practice Tip:* Taxpayers selling property to a related party on an installment basis should consider a bargain sale if the possibility exists that at a later time (either during life or through the estate) a portion of the contract may be canceled as a gift or inheritance. The advantages of a bargain sale include:

- Lower taxable gain on sale.
- Requires only one gift tax return.

The advantages of gifts of installment payments include:

- May avoid dipping into \$625,000 estate exemption (\$650,000 for 1999, increasing yearly) by sheltering a significant portion of the annual gifts below the \$10,000 exclusion.
- Higher adjusted basis of property in hands of buyer.
- Flexibility in decision whether to continue annual gift program.

### **Predeath Installment Sales to Family Members**

The basis of property in the hands of a person acquiring the property from a decedent is the fair market value of the property at the date of the decedent's death (identical to the value used in the decedent's gross estate, i.e. the stepped-up value) [Sec. 1014].

If property is sold prior to death on an installment note basis, the death of the seller results in the fair market value of the receivable being included in the estate subject to the federal estate tax; however, the basis of the obligation is *not* increased. The decedent's estate and any eventual heirs continue to report the same gain as the decedent for income tax purposes [Sec. 691(a)(4)].

As in the previous section related to bargain sales, the gain associated with the principal payments on an installment contract constitutes "income in respect of a decedent."

"Income in respect of a decedent" is the right to receive income that a decedent possessed at the time of death. This would include such items as accrued wages, installment sale receivables, etc. In effect, these rights do not receive the "step-up" in basis upon a taxpayer's death.

If payments are made to a decedent's estate, gain will be recognized by the estate.

If a decedent's will calls for cancellation of the contract, gain will be recognized by the estate in its final fiduciary return [Sec. 691(a)(5)].

Finally, if beneficiaries succeed to the contract payments, they will recognize income using the decedent's original gross profit percentage [Reg. Sec. 1.691(a)-5(a)].

*Practice Tip:* The "to sell" or "not to sell" decision for an aging farmer continues to be a difficult one. Sales prior to death will "lock-in" income tax gain on the difference between the sale price and tax basis. Conversely, if property is held until death, its subsequent sale by heirs will not have any income tax consequences. The potential problems with this "wait until death" tactic are, however, significant and include:

- The property may be appreciating rapidly in value and the value that needs to be included in a decedent's estate can be fixed at the current level by conducting an installment sale.
- The personal residence may be eligible for the Sec. 121 \$250,000/\$500,000 exclusion of gain on sale.
- Heirs may not wish to wait until death to acquire property, especially farm assets which are essential to business operation.
- Creditors such as nursing homes may have greater access to unsold property.
- In the case of agricultural land, the buyer may wish to purchase land from a related party to insure the availability of the 6% interest rate [Sec. 483(e)].

## ALLOCATION ON SALE OF FARM ASSETS

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Generally it will be beneficial for the seller of farm real estate which includes a residence to make effective use of the new Section 121, allowing exclusion from income of up to \$250,000 (\$500,000 on a joint return) of gain on the sale or exchange of a principal residence.

### Why An Allocation Is Necessary

The sale of a farm normally involves the sale of business and nonbusiness property. A personal residence is a nonbusiness capital asset. The selling price and cost must be allocated between the business assets and the residence, including the immediate outbuildings relating to it.

The Sec. 121 exclusion often makes it very beneficial to the seller to allocate as much of the sales price as possible to the personal residence. For sales of a principal residence after May 6, 1997, taxpayers may be able to exclude all or part of the gain on sale—up to \$250,000 (\$500,000 for joint filers). If the home is used partly for business, the exclusion applies only to the part that is for personal use. To qualify for the exclusion, the taxpayer must, during the five-year period ending on the date of sale, have owned the home for at least two years, and lived in the home as a principal residence for at least two years.

### How To Do It and Why

In a sale of mixed property (i.e., land, buildings and equipment), the allocation of the selling price should be based on the ratio of fair market value of each item to the total fair market value of all the property sold. In the absence of a specific allocation, the selling price and the payments in the year of sale are to be apportioned among the assets sold according to their respective values.

Revenue Ruling 68-13 permitted an allocation of the contract price to specific assets in the contract, so that the initial payments on the contract could be attributed to one specific asset [*Rev. Rul. 68-13*, 1968-1 CB 195; *Rev. Rul. 55-79*, 1955-1 CB 370].

For installment sales, it is most advantageous to the purchaser of farmland to indicate in the purchase agreement that the downpayment (and possible follow-up payments) go first to the purchase of the residence.

By doing so, the interest paid on the contract that is a fully deductible business expense is maximized, reducing self-employment taxable income on Schedule F.

This would also be advantageous to the seller if he or she is using Section 121, since the tax on the business property would be deferred to a later date.

### **Allocation of Sales Price to Fertilizer and Chemicals**

A taxpayer engaged in the business of farming may elect to deduct expenditures for the purchase or acquisition of fertilizer, lime, and similar soil nutrients [Sec. 180(a)]. Without Section 180, expenditures for fertilizer would require capitalization because of the creation of an asset with a life extending beyond the end of the tax year. Portions of prior-year fertilizer and chemical applications have carryover benefits to the future, often extending several years. Farmland which has been well-fertilized and properly treated with chemicals in the past will often bring a premium price when offered for sale.

The IRS National Office has ruled that a corporate taxpayer was not allowed 7-year amortization for purchased residual fertilizer supply in a land acquisition, where the farm purchase was in tandem with the individuals who owned the corporation [TAM 9211007].

The corporate taxpayer who claimed the fertilizer deduction had purchased the depreciable improvements and residual fertilizer rights to the farm, while the individual stockholders purchased the land itself. The IRS ruled that the corporation was not the beneficial owner of the fertilizer supply as it was not the owner of the land, and the fertilizer carryover was inseparable from the land. Also, the IRS explained that to claim an amortization deduction for exhaustion of fertilizer acquired with land, the taxpayer must establish the value of the fertilizer and the period of its effectiveness.

While the allocation of a portion of the farm purchase to residual chemical and fertilizer supply can produce ordinary business deductions for the buyer, it should be noted that this allocation will likely produce ordinary income to the seller [*Bliss Dairy, Inc.*, 103 S. Ct. 1134, U.S., 1983].

Because of this "conflict of interest" and for documentation purposes, it would be desirable for the land purchaser to secure a written allocation to the residual fertilizer and chemical supply in the purchase contract. Presumably the portion of the sale price allocated to fertilizer and chemicals would need to be recaptured as ordinary income by the seller in the year of sale.

*Practice Tip:* Soil testing and soil surveys by agronomists or other soil testing services can provide accurate data on the extent of residual fertilizer supply. To the extent that the residual supply in the acquired farm exceeds normal area levels (again as supplied by the testing service), an amortizable asset or a Section 180 deduction exists, depending on estimated useful life.

Soil samples taken at acquisition and again at year end can assist in establishing the period of usefulness of the nutrients. Also, the content of the various fertilizers present in the soil can generally be evaluated by the agronomist in terms of the carryover benefit period.

### Potential Depreciation Recapture

Often the sale of farm property on the installment method will produce substantial immediate depreciation recapture income. A sale or disposition of property often involves a combination of Section 1245 depreciation recapture property and other nonrecapture property. The selling price must be allocated to the assets based on fair market value. Because a buyer and seller often have opposing positions towards the allocation of the selling price, it may be beneficial to reach an arm's length agreement which is designated in writing in the contract.

*Practice Tip:* A written agreement between a buyer and seller as to the allocation of a sale price is binding on both, if the transaction is an "applicable asset acquisition" [Sec. 1060(a)].

The "applicable asset acquisition" rules will generally not apply to a sale of farm realty, as the sale must consist of a transfer of assets which constitute a trade or business (with the regulations referring to a group of assets to the extent constituting an active business within the Section 355 reorganization rules, and to the extent that goodwill is attachable) [Sec. 1060(c)(1); Reg. Sec. 1.1060(b)(2)].

To the extent that a sale of farm real property is combined with sufficient other farm assets so as to constitute an "applicable asset acquisition," both the buyer and seller would also be required to attach IRS Form 8594, Asset Acquisition Statement, to their respective tax returns, to disclose the allocation to the categories of assets which were transferred.

Effective for dispositions made after June 6, 1984, any depreciation recapture income under Sections 1245 or 1250 is recognized immediately in the year of disposition [Sec. 453(i)(1)(A)]. This income is reported independently of any cash collected on principal in the year of sale. Installment reporting is allowed for any remaining capital gain, after recognition of the depreciation recapture and adjustment of basis upward for the depreciation recapture income.

#### Example 6-2

Taxpayer D is selling an item of equipment for a total sales price of \$10,000, payable at \$2,500 per year over 4 years (plus interest as required by statute).

The data with respect to the sale and the gain computation is as follows:

Sale price		\$10,000
Original cost	\$ 9,000	
Less depreciation	<u>(7,000)</u>	
Adjusted basis		<u>2,000</u>
Total Gain		<u>\$ 8,000</u>

**Example 6-2 (con't)****Installment Computation:****Gain in Year 1**

All depreciation recapture	\$ 7,000	(ordinary)
\$2,500 cash × 10%*	250	(cap. gain)
Yr. 2 \$2,500 cash × 10%	250	(cap. gain)
Yr. 3 \$2,500 cash × 10%	250	(cap. gain)
Yr. 4 \$2,500 cash × 10%	250	(cap. gain)
Total Gain	<u>\$ 8,000</u>	

\*Gross profit ratio: \$1,000 remaining capital gain ÷ \$10,000 sale price = 10%.

*Practice Tips:* The tax preparer should be alert to “hidden” Section 1245 assets such as bins, tiling, fences, and single purpose agricultural structures such as hog and cattle structures accompanying a farm real estate sale. It may be necessary to advise a seller to secure a larger down payment in an installment sale, to secure enough cash to cover the tax costs arising from recapture in the year of sale.

Possibly negotiate the value of each individual tangible asset identified within the contract, with the intention of minimizing the values of Section 1245 property for seller purposes.

Possibly fragment the sale by selling Section 1245 items in different tax years.

**Treatment of Growing Crops**

Growing crops which are sold as a part of a land transaction to the same buyer are treated as a Section 1231 asset and accordingly, are fully eligible for capital gain treatment [Sec. 1231(b)(4)]. Costs of raising a standing crop which qualifies as a Section 1231 asset are disallowed to the seller and are added to basis to determine the gain or loss on the land transaction [Sec. 268]. These capitalized costs would include crop expenses and allocable depreciation.

*Practice Tip:* The value of those growing crops should be stated in the purchase contract, since the tax basis allocated to them would be deductible by the buyer at the time the crop is eventually sold.

**Split-Interest Land Acquisitions**

The Tax Court has affirmed that related parties (such as a corporation and its controlling shareholder) may enter into split-interest acquisitions of assets (*Richard Hansen Land Inc. v. Comm.*, TC Memo 1993-248). A split-interest arrangement involves one party acquiring a temporary interest in the asset, with the other party acquiring a remainder interest.

The temporary interest may either be based on a term of years (i.e., a term certain) or defined by reference to one or more lives (i.e., a life estate); the remainder holder then succeeds to full ownership after the expiration of the term certain or life estate.



The *Hansen* case involved a corporation which acquired a 30-year term interest in farm land, with the controlling shareholder acquiring the remainder interest. Under the law in effect at that time (prior to mid-1989 addition of IRC Section 167(e)), the term interest holder's ownership was amortizable, as the term or life estate holder was considered to have acquired a wasting asset. For term interests or life estates acquired after July 28, 1989, no amortization is allowed if the remainder portion is held, directly or indirectly, by a related party [Sec. 167(e)].

However, the split-interest technique may still have application in two situations:

1. Using corporate funds to acquire a term interest in real estate, with the residual of remainder ownership acquired by a shareholder (thus using a substantial amount of corporate dollars to acquire the real estate, but with the title eventually vested outside of the corporation to prevent any double taxation threat).
2. Arranging a split-interest acquisition with unrelated parties, to accomplish acquisition of land so it can be amortized.

If the acquisition is nonamortizable because it involves related parties, the term holder's basis in the property (i.e., the corporate tax basis) is reduced annually by the amortization which would have been allowable, and the remainder holder's tax basis (i.e., the shareholder's tax basis) is increased annually by this disallowed amortization [Sec. 167(e)(3)]. This has the effect of assuring the remainder holder of a full tax basis in real estate.

To arrange an unrelated party acquisition (e.g., family farm corporation as term holder and daughter-in-law of the majority shareholder as remainderman), the IRC Section 267 related party rules and family attribution definitions must be closely scrutinized.

To determine the proportionate share of cost to the term holder and remainder holder, the monthly AFR interest rate (technically, the 120% mid-term rate compounded annually, rounded to the nearest 2/10ths of 1%) is used, along with the actuarial tables of IRS Publications number 1457 and 1458.

Also, related party split-interest purchases with *individuals* (e.g., father and son split-interest acquisition of farmland) should be avoided.

Section 2702 treats the person acquiring the term interest as having made a gift of the value of the term ownership to the purchaser of the remainder right. Here, the related party definition is very broad, extending to in-laws, nieces, nephews, uncles and aunts.

*Practice Tip:* The split-interest technique can be of significant benefit when an existing C corporation has accumulated significant liquid assets (often this has occurred through many years of accumulated income at the lower 15% tax rate tier). If the corporation acquires a lengthy term interest, such as 30 years, it will furnish most of the cash for the land acquisition (e.g., 90%, although this depends on the particular AFR at the month of purchase). However, the land will eventually be owned in full by the remainderman, at its full tax basis.

## TAX-FREE EXCHANGES UNDER SECTION 1031

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Whenever a taxpayer is selling farm assets, an alert tax consultant should be aware of the tax-free exchange rules if there is a possibility of the seller's desire to reinvest in like-kind property.

### Requirements for a Tax-Free Exchange

Nontaxable exchange treatment is available if all of the following requirements are met:

- The form of the transaction is an exchange;
- Both the property transferred and the property received are held either for productive use in a trade or business or for investment; and
- The property transferred and received is "like-kind" property [Sec. 1031].

Like-kind exchanges can include business for business, business for investment, investment for business, or investment for investment property. Even though securities (stocks and bonds) are held for investment, they do not qualify for like-kind exchange treatment. Like-kind refers to the nature or character of the property, not its use, grade or quality.

Like-kind property rules are very liberal in the case of real estate (e.g., farm for apartment is considered like-kind, any unimproved real estate for any improved real estate is considered like-kind).

General Asset Classes are described in Revenue Procedure 87-56, 1987-2 CB 674, and consist of 13 generic personal property groupings (e.g., office furniture and fixtures, information systems, autos, etc.).

Easements of a long-term duration can be considered the equivalent of full ownership in the real estate. Earlier authorities [Rev. Rul. 72-255 and *W.J. Weinberg*, 326 F2d 157, 64-1 USTC ¶9156] established that the granting of a perpetual easement where no beneficial interest is retained is treated as an outright sale. The IRS has ruled that a perpetual agricultural conservation easement on a farm qualifies for like-kind exchange treatment with a fee simple interest in replacement real property (PLR 9232030).

Like-kind property rules are less liberal for personal property such as farm equipment (i.e., a farm truck for a tractor is *not* considered like-kind) [IRS Pub. 225, Ch. 10].

*Note:* On April 11, 1991, final regulations at Regulation Section 1.1031(a) – (2) were adopted which define like-kind tangible personal property as property within the same depreciation asset class. The truck and tractor are not within the same depreciable class, whereas a combine traded for a tractor would qualify for like-kind exchange treatment.

For exchanges of tangible personal property after April 10, 1991, the property must either be of like-kind or "like-class" (i.e., within the same General Asset Class for depreciation) [IRS Pub. 225, Ch. 10], but livestock of different sexes are not like-kind [Sec. 1031(e)].

The nonrecognition treatment for like-kind exchanges is mandatory. A taxpayer who wants to recognize a realized gain or loss must structure the transaction to avoid requirements for a like-kind exchange.

*Practice Tip:* Because of the limits on depreciation deductions for passenger vehicles and light pickup trucks, taxpayers may often find that market value is less than adjusted tax basis at disposition. In this case, a Section 1031 trade-in should be avoided, as this defers the high basis into the next vehicle. Rather, an outright sale allowing an immediate Section 1231 ordinary loss is preferable. However, in Revenue Ruling 61-119, exchange treatment was imposed where a taxpayer sold one machine to a dealer and concurrently purchased a new machine from the same dealer.

### **Basis Adjustments**

If the exchange qualifies for nonrecognition, the basis of property received must be adjusted to reflect any deferred gain or loss. The basis of like-kind property received in the Section 1031 exchange is determined as follows:

$$\begin{array}{l}
 \text{Adjusted basis of like-kind property given} \\
 + \text{Adjusted basis of boot given (if any)} \\
 - \text{Loss recognized (if any) on boot given} \\
 + \text{Gain recognized (if any)} \\
 \hline
 - \text{FMV of boot received (if any)} \\
 \hline
 = \text{Basis of like-kind property received}
 \end{array}$$

The statutes provide time limitations in regard to property involved in a Section 1031 exchange if property is surrendered prior to receiving the exchange property (i.e., a deferred exchange). Assets to be received must be identified within 45 days of when a taxpayer relinquished his old property. The exchange property must be received before the earlier of:

- The day which is 180 days after the date on which the taxpayer transfers the property given up in the exchange; or
- The due date, including extensions, of the transferor's return for the tax year in which the property was relinquished [Sec. 1031(a)(3)].

### **Practical Examples**

Typical farm exchanges include the following;

- Simple two-party transfer (common with personal property such as equipment trade-ins).

Three-corner exchange.

- X wishes to acquire property from Y and Y wants property presently owned by Z.
- A tax-free exchange is achieved for Y by having X buy the property from Z and then having X and Y exchange properties.
- Or, Y and Z might first exchange properties, followed by X's acquisition of property from Z.

*Query:* The Internal Revenue Service has issued Form 8824 to report like-kind exchanges (see following page). While the form is obviously required for real estate exchanges, will the IRS also force its completion for all farm equipment trade-ins? Note the instructions for Lines 1 and 2 of Form 8824: "For *personal property*, enter a short description."

EXHIBIT 6-1

Form 8824

Like-Kind Exchanges (and nonrecognition of gain from conflict-of-interest sales)

OMB No. 1545-1190

1997

Department of the Treasury Internal Revenue Service

See separate instructions. Attach to your tax return. Use a separate form for each like-kind exchange.

Attachment Sequence No. 49

Name(s) shown on tax return

Identifying number

Part I Information on the Like-Kind Exchange

Note: If the property described on line 1 or line 2 is real or personal property located outside the United States, indicate the country.

- 1 Description of like-kind property given up
2 Description of like-kind property received
3 Date like-kind property given up was originally acquired
4 Date you actually transferred your property to other party
5 Date the like-kind property you received was identified
6 Date you actually received the like-kind property from other party
7 Was the exchange made with a related party?

Part II Related Party Exchange Information

8 Name of related party Related party's identifying number

Address (no., street, and apt., room, or suite no.)

City or town, state, and ZIP code

Relationship to you

- 9 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did the related party sell or dispose of the like-kind property received from you in the exchange?
10 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did you sell or dispose of the like-kind property you received?
11 If one of the exceptions below applies to the disposition, check the applicable box:

Part III Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received

Caution: If you transferred and received (a) more than one group of like-kind properties, or (b) cash or other (not like-kind) property, see Reporting of multi-asset exchanges in the instructions.

Note: Complete lines 12 through 14 ONLY if you gave up property that was not like-kind. Otherwise, go to line 15.

Table with 25 rows for calculations: 12 Fair market value (FMV) of other property given up, 13 Adjusted basis of other property given up, 14 Gain or (loss) recognized on other property given up, 15 Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred. See instructions, 16 FMV of like-kind property you received, 17 Add lines 15 and 16, 18 Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses not used on line 15. See instructions, 19 Realized gain or (loss). Subtract line 18 from line 17, 20 Enter the smaller of line 15 or line 19, but not less than zero, 21 Ordinary income under recapture rules. Enter here and on Form 4797, line 16. See instructions, 22 Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies. See instructions, 23 Recognized gain. Add lines 21 and 22, 24 Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions, 25 Basis of like-kind property received. Subtract line 15 from the sum of lines 18 and 23.

Name(s) shown on tax return. Do not enter name and social security number if shown on other side.

Your social security number

**Part IV Section 1043 Conflict-of-Interest Sales.** See instructions. Attach a copy of your certificate of divestiture.

*Note: This part is only to be used by officers or employees of the executive branch of the Federal Government for reporting nonrecognition of gain under section 1043 on the sale of property to comply with the conflict-of-interest requirements. This part can be used only if the cost of the replacement property exceeds the basis of the divested property.*

<b>26</b>	Description of divested property ▶		
<b>27</b>	Description of replacement property ▶		
<b>28</b>	Date divested property was sold (month, day, year)		<b>28</b> / /
<b>29</b>	Sales price of divested property. See instructions	<b>29</b>	
<b>30</b>	Basis of divested property	<b>30</b>	
<b>31</b>	Realized gain. Subtract line 30 from line 29		<b>31</b>
<b>32</b>	Cost of replacement property purchased within 60 days after date of sale	<b>32</b>	
<b>33</b>	Subtract line 32 from line 29. If zero or less, enter -0-		
<b>34</b>	Ordinary income under recapture rules. Enter here and on Form 4797, line 10. See instructions		<b>34</b>
<b>35</b>	Subtract line 34 from line 33. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797. See instructions		<b>35</b>
<b>36</b>	Recognized gain. Add lines 34 and 35		<b>36</b>
<b>37</b>	Deferred gain. Subtract line 36 from line 31		<b>37</b>
<b>38</b>	Basis of replacement property. Subtract line 37 from line 32		<b>38</b>

**Paperwork Reduction Act Notice.** We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must

be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by Internal Revenue Code section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is: **Recordkeeping, 26 min.; Learning about the law or the form, 28 min.; Preparing the form, 1 hr., 2 min.; Copying, assembling, and sending the form to the IRS, 27 min.**

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. See the instructions for the tax return with which this form is filed.



1997

Department of the Treasury  
Internal Revenue Service

# Instructions for Form 8824

## Like-Kind Exchanges

Section references are to the Internal Revenue Code unless otherwise noted.

### General Instructions

#### A Change To Note

Generally, for exchanges after June 8, 1997, personal property used predominantly within the United States and personal property used predominantly outside the United States are not property of a like kind. See section 1031(h).

#### Purpose of Form

Use Parts I, II, and III of Form 8824 to report the exchange of business or investment property for property that is of a like kind (section 1031). Use Part IV to report the nonrecognition of gain from conflict-of-interest sales by certain members of the executive branch of the Federal Government (section 1043).

For more information on like-kind exchanges, see section 1031 and its regulations and Pub. 544, *Sales and Other Dispositions of Assets*.

#### When To File

For each like-kind exchange, you must file Form 8824 for the tax year you transferred property to another party in an exchange. If you made a related party (defined later) exchange, you must file Form 8824 for 2 years following the year of the exchange.

#### Like-Kind Exchanges

Generally, if you exchange business or investment property solely for business or investment property of a like kind, no gain or loss is recognized under section 1031. If you also receive other property or money, a gain is recognized to the extent of the other property or money received, but a loss is not recognized.

Section 1031 does not apply to exchanges of inventory, stocks, bonds, notes, other securities or evidence of indebtedness, and certain other assets. See section 1031(a)(2).

**Like-kind property.** Properties are like kind if they are of the same nature or character, even if they differ in grade or quality. Personal property of a like class is also considered like kind. However, livestock of different sexes is not like-kind property. Also, personal property used predominantly in the United States and personal property used predominantly

outside the United States are not like-kind properties. See Pub. 544 for more details.

Real property is of the same kind as other real property, regardless of whether the properties are improved or unimproved. However, real property in the United States and real property outside the United States are not like-kind properties.

**Deferred exchanges.** A deferred exchange occurs when the property received in the exchange is not received immediately upon the transfer of the property given up. For a deferred exchange to qualify as like kind, you must:

- Identify the replacement property you receive within 45 days after the date you transferred the property given up, and
- Receive the new property by the earlier of (a) 180 days after the date you transferred the property given up, or (b) the due date of your tax return for the year of the transfer (including extensions).

Property is identified by notifying, in writing, another party to the exchange (other than a related party) of your selection of the property. Identification may also be made in a written agreement for the exchange of properties.

**Multi-asset exchanges.** A multi-asset exchange occurs when the exchanged properties consist of the transfer and receipt of more than one group of like-kind properties. For example, an exchange of land, vehicles, and cash for land and vehicles would be a multi-asset exchange. An exchange of land, vehicles, and cash for only land would not be a multi-asset exchange. A multi-asset exchange also occurs if only one group of like-kind properties is created but more than one property is transferred or received within that group.

Special rules apply when figuring the amount of gain recognized and the basis of properties received in a multi-asset exchange. For details, see Regulations section 1.1031(j)-1.

**Reporting of multi-asset exchanges.** If you transferred and received (a) more than one group of like-kind properties, or (b) cash or other (not like-kind) property, do not complete lines 12 through 18 of Form 8824. Instead, attach a sheet showing how you figured the realized and recognized gain, and enter the correct amount for lines 19 through 25. Report recognized gain on Schedule D, Form 4797, *Sales of Business Property*, or Form 6252, *Installment Sale Income*, whichever applies.

**Related party exchanges.** Special rules apply to like-kind exchanges made with a related party. A related party includes your spouse, child, grandchild, parent, brother or sister, or a related corporation, S corporation, partnership, or trust. See section 1031(f).

If either you or the related party disposes of property received in an exchange before the date that is 2 years after the last transfer of property from the exchange, the deferred gain or (loss) from line 24 must be reported on your return for the year of disposition (unless an exception on line 11 applies).

If you are filing this form for 1 of the 2 years following the year of the exchange, complete Parts I and II. If both lines 9 and 10 are "No," stop there, and attach the form to your return. If either line 9 or line 10 is "Yes" and an exception on line 11 applies, check the applicable box on line 11, stop there, and attach the form to your return. If no line 11 exceptions apply, complete Part III. The deferred gain or (loss) from line 24 must be reported on this tax year's return as if the exchange had been a sale.

An exchange structured to avoid related party rules is not treated as a like-kind exchange. See section 1031(f)(4).

### Specific Instructions

**Lines 1 and 2.** For real property, show the address, type of property, and country if outside the United States. For personal property, enter a short description.

**Line 5.** See **Deferred exchanges** above.  
**Line 7.** See **Related party exchanges** above.

**Line 11c.** If you believe that you can establish to the satisfaction of the IRS that tax avoidance was not a principal purpose of both the exchange and the disposition, attach an explanation. See Pub. 537, *Installment Sales*, for exceptions where tax avoidance is not a principal purpose.

**Lines 12, 13, and 14.** If you gave up other property in addition to the like-kind property, enter the fair market value (FMV) and the adjusted basis of the other property on lines 12 and 13, respectively.

The gain or (loss) from this property is figured on line 14 and must be reported on your return. Report gain or (loss) as if the exchange was a sale.

**Line 15.** Include on line 15 the sum of the following:

- Any cash paid to you by the other party,
- The FMV of other (not like-kind) property you received, if any, and
- Net liabilities assumed by the other party—the excess, if any, of liabilities assumed by the other party (including mortgages on the property you gave up); over the total of: (a) any liabilities you assumed (or that applied to the property you received), (b) cash you paid to the other party, and (c) the FMV of other property you gave up.

Reduce the sum of the above amounts (but not below zero) by any exchange expenses you incurred. See the example below the line 18 instructions.

**Line 18.** Include on line 18 the sum of the following:

- The adjusted basis of the like-kind property you gave up,
- Exchange expenses, if any (except for expenses used to reduce the amount reported on line 15), and
- Net amount paid to the other party—the excess, if any, of the total of: (a) any liabilities you assumed, (b) cash you paid to the other party, and (c) the FMV of the other property you gave up; over any liabilities assumed by the other party.

See Regulations section 1.1031(d)-2 and the following example for figuring amounts to enter on lines 15 and 18.

**Example.** A owns an apartment house with an FMV of \$220,000, an adjusted basis of \$100,000, and subject to a mortgage of \$80,000. B owns an apartment house with an FMV of \$250,000, an adjusted basis of \$175,000, and subject to a mortgage of \$150,000.

A transfers his apartment house to B, and receives in exchange the apartment house owned by B and \$40,000 cash. Each apartment house is transferred subject to the mortgage on it.

A enters on line 15 only the \$40,000 cash received from B. The \$80,000 of liabilities assumed by B is not included because it does not exceed the \$150,000 of liabilities A assumed. A enters \$170,000 on line 18—the \$100,000 adjusted basis, plus the \$70,000 excess of the liabilities A assumed over the liabilities assumed by B (\$150,000 – \$80,000).

B enters \$30,000 on line 15—the excess of the \$150,000 of liabilities assumed by A over the total (\$120,000) of the \$80,000 of liabilities B assumed and the \$40,000 cash B paid. B enters on line 18 only the adjusted basis of

\$175,000, because the total of the \$80,000 of liabilities B assumed and the \$40,000 cash B paid does not exceed the \$150,000 of liabilities assumed by A.

**Line 21.** If you disposed of section 1245, 1250, 1252, 1254, or 1255 property (see the instructions for Part III of Form 4797), you may be required to recapture as ordinary income part or all of the realized gain (line 19). Figure the amount to enter on line 21 as follows:

- For section 1245 property, enter the smaller of (a) the total adjustments for deductions (whether for the same or other property) allowed or allowable to you or any other person for depreciation or amortization (up to the amount of the gain shown on line 19), or (b) any gain shown on line 20, plus the FMV of non-section 1245 like-kind property acquired.

- For section 1250 property, enter the larger of (a) the excess, if any, of the gain you would have had to report as ordinary income because of additional depreciation (see the Form 4797 instructions for line 26) if you had sold the property over the FMV of the section 1250 property acquired, or (b) any gain shown on line 20.

- The rules for section 1252, 1254, and 1255 property are similar to those for section 1245 property. See Regulations section 1.1252-2(d) and Temporary Regulations section 16A.1255-2(c) for details. If the installment method applies to this exchange:

1. See section 453(f)(6) to determine this year's taxable amount of installment sale income and report it on Form 6252.

2. Enter on Form 6252, line 25 or 36, the section 1252, 1254, or 1255 recapture amount you figured on Form 8824, line 21. Do not enter more than the amount shown on Form 6252, line 24 or 35.

3. Also, enter this amount on Form 4797, line 15.

If not recapturing all the ordinary income this year, you must report on Form 6252 the ordinary income up to the taxable installment sale income in future years until it is all reported.

**Line 22.** Report a gain from the exchange of property used in a trade or business (and other noncapital assets) on Form 4797, line 5 or 16. Report a gain from the exchange of capital assets according to the Schedule D instructions for your return. Be sure to use the date of the exchange as the date for reporting the gain. If the installment method applies to this exchange, see section 453(f)(6) to determine this year's taxable amount and report it on Form 6252.

**Line 24.** If line 19 is a loss, enter it on line 24. Otherwise, subtract any line 23 amount from the line 19 amount, and enter the result. See *Related party exchanges* on page 1 for exchanges with related parties.

**Line 25.** The amount on line 25 is your basis of the like-kind property you received in the exchange. The basis of other property received in the exchange, if any, is its FMV.

## Section 1043 Conflict-of-Interest Sales (Part IV)

If you sell property at a gain according to a certificate of divestiture issued by the Office of Government Ethics (OGE), you may elect to recognize gain on the sale only to the extent that the amount realized on the sale exceeds the cost of replacement property (permitted property) purchased within 60 days after the sale. Permitted property is any obligation of the United States or any diversified investment fund approved by the OGE.

Complete Part IV of Form 8824 only if the cost of the replacement property exceeds the basis of the divested property. Otherwise, report the gain on Schedule D or Form 4797, whichever applies.

Basis in the replacement property is reduced by the amount of the gain not recognized. If you made more than one purchase of replacement property, reduce the basis of the replacement property in the order it was acquired.

**Line 29.** Enter the amount you received from the sale of the divested property, minus any selling expenses.

**Line 34.** Follow these steps to determine the amount to enter.

1. Use Part III of Form 4797 as a worksheet to figure ordinary income under the recapture rules.

2. Enter on Form 8824, line 34, the amount from Form 4797, line 31. Do not attach the Form 4797 (worksheet) to your return.

3. Report the amount from line 34 on Form 4797, line 10, column (g). In column (a), write "From Form 8824, line 34." Do not complete columns (b) through (f).

**Line 35.** If you sold a capital asset, enter any gain from line 35 on Schedule D.

If you sold property used in a trade or business (or any other noncapital asset), report the gain on Form 4797, line 2 or 10, column (g). In column (a), write "From Form 8824, line 35." Do not complete columns (b) through (f).



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## CHAPTER 7

### TAX PLANNING OPPORTUNITIES

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#### OVERVIEW

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An understanding of this chapter will enable you to:

- Identify and put into practice the three most common retirement plans available to farmers, IRAs, SEPs and Keoghs, and know about the new SIMPLEs;
- Identify the applicability of a January 15 estimated income tax payment for farmers;
- Consult with clients on their Social Security benefits questions;
- Use itemized deductions for more farmers through the “staggering” method; and
- Target farm taxable income to the most effective use of tax brackets.

#### INTRODUCTION

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Tax planning for farmers should be a very important part of a tax practitioner’s practice. Farmers have the opportunity to use the cash method of accounting, which makes tax planning vitally important. The effective use of tax brackets is only a part of the whole tax planning concept. Retirement planning is also an area of tax planning which deserves attention. This chapter will review the use of tax brackets along with other tax planning ideas.

#### IRAS, SEPS, SIMPLES, AND KEOGHS

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##### Background

The three most common retirement plans available to self-employed individuals are Individual Retirement Accounts (IRA), Simplified Employee Pension Plans (SEP), and KEOGH or H.R. 10 plans. All three plans are designed to allow a deduction by the individual (or business entity) for contributions to the retirement plan. Distributions made from the plan are taxed in the individual’s personal tax return. Interest earned on the funds in these accounts is tax-deferred until distributed. From a tax planning viewpoint, qualified retirement plans represent the first choice for many taxpayers and planners due to the ability to defer income for a substantial period of time. In addition, beginning in 1997, the SIMPLE (savings incentive match plan for employees) plan is available.

Retirement plans such as IRAs, SEPs, SIMPLEs, and Keoghs allow taxpayers to defer the taxation of income to a later time when funds are withdrawn from the plan.

In addition to the benefit of tax deferral, the plan distributions may be taxed at a lower bracket in retirement years when the distributions are taxed.

## **SIMPLEs**

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Farmers should be advised of the availability of the new SIMPLE retirement plan, beginning in 1997. Under SIMPLE, an employee or a self-employed farmer may set aside up to \$6,000 of earnings annually into a SIMPLE plan. In the case of an employee, the \$6,000 represents a salary reduction on the W-2 (but only for income tax, not FICA, purposes). For the self-employed proprietor or partner, the \$6,000 deduction may be claimed "above-the-line" on page one of Form 1040.

In the case of an employee, an employer contribution is required. Generally, this will be a dollar-for-dollar match of the employee's voluntary set-aside, up to a maximum of 3% of the employee's gross earnings. Alternatively, the employer can provide a 2%-of-compensation funding, but this choice must occur regardless of whether the employee elects voluntary salary reduction.

For farm operators who are employees of their own S corporation or C corporation, the SIMPLE plan could allow as much as a \$12,000 annual funding (i.e., \$6,000 voluntary employee reduction of W-2 earnings, and \$6,000 employer match, assuming the employee W-2 was at least \$200,000—because of the 3%-of-W-2 matching limit.

To be eligible for SIMPLEs, farmers must have 100 or fewer employees and meet other requirements [Sec. 408(p)].

## **IRAs**

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**Basic Rules.** Contributions of up to \$2,000 or 100% of taxable earnings, whichever is less, can be made to an IRA [Sec. 219(b)(1)]. Beginning in 1997, joint filers can each contribute \$2,000 to an IRA, even if one spouse has little or no income, assuming the combined income of the spouses is at least as great as the combined IRA contribution amount [Sec. 219(c)(1)].

Eligible earnings for IRA purposes include net farm or business income from a proprietorship or partnership, wages, tips, commissions, fees, taxable alimony and separate maintenance payments [Sec. 219(f)(1)].

A deduction is allowed on page 1 of Form 1040 for allowable IRA contributions.

The deduction allowed may be reduced or eliminated if the taxpayer or spouse is an active participant in an employer retirement plan during any part of a plan year [Sec. 219(g)(1)].

The deduction is phased out depending on filing status and “modified adjusted gross income” (defined below). The following table shows the 1998 levels of income at which an IRA deduction is reduced or eliminated:

<b>Filing Status:</b>	<b>IRA Deduction is Reduced if Modified AGI is:</b>	<b>IRA Deduction is Eliminated if Modified AGI is:</b>
Single, or head of household	\$30,000–\$40,000	\$40,001 or more
Married—joint return, or qualifying widow(er)	\$50,000–\$60,000	\$60,001 or more
Married—separate return	\$0–\$10,000	\$10,000 or more

Beginning in 1998, if one spouse is covered by an employer plan, the other spouse, if not covered, may be able to deduct an IRA contribution. In such a situation, the phase-out amount of modified AGI is \$150,000–\$160,000 for joint filers.

**Calculation of a Partial IRA Deduction.** If a taxpayer is covered by an employer’s plan and the taxpayer’s income is within the modified AGI phase-out range, the partial IRA deduction is computed at a phase-out rate of 20%, using a worksheet found in the Form 1040 instructions. As modified AGI increases within the \$10,000 phase-out range, each \$1 of increase reduces the eligible IRA amount by \$.20 (see Example 7–2 for an illustration of a phase-out calculation). If neither the taxpayer nor spouse is covered by an employer plan, the AGI phase-out does *not* apply.

If a taxpayer is married and both the taxpayer and spouse have IRAs, the deduction for each should be computed separately.

“Modified adjusted gross income” is AGI from Form 1040, line 32, computed *without* any:

- IRA deduction;
- Foreign earned income exclusion, or foreign housing exclusion or deduction; or
- Exclusion of U.S. Savings bond interest income for higher education costs [Sec. 219(g)(3)].

A nondeductible IRA contribution is equal to the difference between the permitted contribution and the deductible contribution [Sec. 408(o)(2)(B)(i)]. Earnings on nondeductible IRA contributions are deferred until distributed, the same as for deductible contributions. Nondeductible IRA contributions have a “cost basis.” The cost basis is equal to the sum of the nondeductible contributions made to an IRA less any distributions of those amounts. Form 8606 must be filed with the individual return to report a nondeductible IRA contribution.

Starting in 1998, farmers also have the option of contributing amounts to the new Roth IRAs, subject to eligibility criteria being met. The contributions are nondeductible, but future qualified distributions are also totally tax free.

As stated, with the Roth IRA, contributions are not deductible, but the funds do grow tax free. Taxpayers with joint AGI of \$150,000 or less (\$95,000 or less for singles) can open a Roth IRA. There are certain restrictions on withdrawals with a Roth IRA ([IRC Sec. 408A]).

*Practice Tip:* In determining whether an individual is an "active participant" in another qualified retirement plan for purposes of an IRA limitation, the regulations clarify that a person is only a participant in a discretionary contribution plan if their account either receives a current employer contribution or an allocation of forfeitures in the current year [Notice 87-16, 1987-1 CB 446].

#### **Example 7-1**

George is an unmarried farm proprietor who in past years has occasionally funded a defined contribution Keogh plan.

For 1998, George will make no Keogh plan contribution, and there are no employee forfeitures within this plan.

George is eligible for an IRA deduction this year, even if his modified AGI exceeds \$35,000.

### **SEPs and Keoghs**

SEPs are designed as an alternative to more complex retirement plans. A SEP is an arrangement under which an employer makes contributions to an employees' IRA account and his own account [Sec. 408(k)]. The self-employed farmer is allowed a deduction on Schedule F for any employee SEP contribution and a deduction for his own contribution on Form 1040, page 1 as an adjustment to income.

A SEP does not require forms to be filed with the IRS, regardless of size of the plan assets or the number of employee participants.

Keoghs, or HR-10 plans, are qualified retirement plans which require annual filing. If the taxpayer and spouse are the only participants, Form 5500EZ must be filed only if the value of the plan is over \$100,000. Or, if there are other employees, Form 5500-C/R must be filed.

There are two types of Keogh plans:

- **Defined Contribution Plans.** Generally, contributions to the plan are based on the employer's profits, with the funding an annual discretionary decision.
- **Defined Benefit Plans.** Contributions are fixed and are not based on the employer's profits, but rather reference to a target retirement amount for each employee.

The employer may contribute to the employee SEP or Keogh plan up to the following limits:

Profit sharing plan	lesser of 15% of wages (limited to \$160,000) or \$30,000
Money purchase pension plan	lesser of 25% of wages (limited to \$160,000) or \$30,000

A self-employed individual can contribute to his own SEP or Keogh account up to a maximum of \$30,000. Contribution rates are applied to earned income. A self-employed individual's earned income is determined after the deduction for half of self-employment tax and a reduction for the self-employed participant's deductible contribution to the SEP or Keogh plan [Sec. 401(c)(2)(A)(v) and (vi)].

This requires a simultaneous equation that reduces the self-employed individual's maximum contribution percentage (based on pre-contribution earned income).

*(Text continued on page 231)*

The following table shows the contribution rates:

<b>% Contribution Based on Employee's Gross W-2 Income</b>	<b>Allowable % of Net Precontribution Self-employed Income (net of 1/2 SE tax) of Proprietor/Partner</b>
1%	.9901%
2	1.9608
3	2.9126
4	3.8462
5	4.7619
6	5.6604
7	6.5421
8	7.4074
9	8.2569
10	9.0909
11	9.9099
12	10.7143
13	11.5044
14	12.2807
15 (profit-sharing plan maximum)	13.0435
16	13.7931
17	14.5299
18	15.2524
19	15.9664
20	16.6667
21	17.3554
22	18.0328
23	18.6992
24	19.3548
25 (money-purchase pension plan maximum)	20.0000

Pension and profit-sharing plans are available for corporations.

### Combination of IRA and SEP/Keogh Contributions

In certain circumstances, a farmer may want to contribute the maximum to both his IRA and SEP or Keogh plans. If the farmer's modified adjusted gross income (MAGI) is below the deduction limitations, contribution calculations are simplified. If MAGI is above the limits the calculation becomes more complex.

#### Example 7-2

Roger, a farmer, files a joint tax return, and in 1998 shows total income from the following forms:

Schedule B (Interest income)	\$ 200
Schedule D (Capital gains)	1,000
Schedule F (Net farm income)	<u>50,000</u>
Total Income	<u>\$51,200</u>

Roger would like to contribute the maximum amount to his SEP and IRA plans.

The maximum contribution is computed as follows:

SEP Contribution:	
Net farm income	\$50,000
1/2 of self-employment tax (\$50,000 × .9235 × .153 ÷ 2)	<u>(3,535)</u>
	\$46,465
SEP rate	× <u>13.043%</u>
SEP Contribution	<u>\$ 6,060</u>
IRA Contribution:	
Total income	\$51,200
Less: 1/2 SE tax	(3,535)
SEP contribution	<u>(6,060)</u>
Modified AGI	41,605
Modified AGI limitation	<u>50,000</u>
Difference	8,395
× Phase-out %	× <u>20%</u>
	<u>1,679</u>
Round up – Deductible IRA Contribution	<u>\$ 1,680</u>
Maximum SEP contribution	\$ 6,060
Maximum IRA contribution	<u>1,680</u>
Total deductible retirement plan contributions	<u>\$ 7,740</u>

## Other Requirements

Family members employed by a farmer must be covered by all retirement plans if eligibility requirements are met.

Lump-sum distribution rules apply to entire distributions from a qualified plan.

- Keogh plans are qualified plans, but IRAs and SEP plans are not qualified plans.
- Therefore, the special lump-sum averaging rules may be used for entire distributions of Keogh plans, but not for IRA or SEP plans [Sec. 402(e)].

Exhibit 7-1 at the end of this chapter details various attributes of IRAs, SEPs and Keogh plans.

## ESTIMATED TAX PAYMENTS FOR QUALIFIED FARMERS

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### Background

Qualified farmers have a unique opportunity to avoid quarterly tax estimates which are required for other individuals. This section defines a qualified farmer and discusses the tax estimate requirements for farmers.

### Definitions

A qualified farmer is an individual:

- Whose gross income from farming for the taxable year is at least 66 2/3% of the total gross income from all sources for the taxable year; or
- Whose gross income from farming shown on the return of the preceding taxable year is at least 66 2/3% of the total gross income from all sources for that preceding year [Sec. 6654(i)(2)].

Gross income from farming includes the following:

- Schedule F and Form 4835 gross income;
- Allocated gross farm income from a pass-through entity; and
- Gains from sales of draft, breeding, dairy or sporting livestock.

Gross income from farming does not include:

- Cash rent from farm land;
- Gain on sale of farm machinery or farm land; or
- Custom farm operation income [IRS Pub. 225, Ch. 2].



**Compliance Requirements**

If a taxpayer meets the  $2/3$  gross income test for the previous year but not the current year, and files the current year tax return and pays the tax due by March 1, Form 2210F should be attached to the tax return with the following notation:

**EXEMPT FARMER:** More than  $2/3$  of prior-year gross receipts from active farming, per Section 6654(i)(2)(B).

The following worksheet can be used to determine if an individual meets the  $2/3$  farm gross receipts test:

*(Worksheet appears on page 234)*

**QUALIFIED FARMER DETERMINATION**  
(For Estimated Tax Exception)

**1 – Determination of Total Gross Income:**

Form 1040	All wages	Line 7	\$ _____
Form 1040	Taxable interest income	Line 8a	_____
Form 1040	Dividend income	Line 9	_____
Form 1040	Taxable state tax refund	Line 10	_____
Form 1040	Alimony received	Line 11	_____
Form 1040	Capital gain distributions	Line 13	_____
Form 1040	Taxable IRAs	Line 15b	_____
Form 1040	Taxable pensions	Line 16b	_____
Form 1040	Taxable unemployment	Line 19	_____
Form 1040	Taxable soc. sec. benefits	Line 20b	_____
Form 1040	Other income	Line 21	_____
Schedule C	Gross income	Line 7	_____
Schedule D	Net gain	Note 3	_____
Schedule E	Rent	Line 3	_____
Schedule E	Royalties	Line 4	_____
Schedule E	Share of partnership and S corp. income (see Note 1)	Line 31	_____
Schedule E	Estates and trusts (see Note 1)	Line 36	_____
Schedule F	Gross income	Line 11/52	_____
Form 4797	Ordinary gain and losses	Line 18	_____
Form 4835	Gross rent	Line 7	_____
	<b>Total Gross Income</b>		<b>\$ _____</b>

**2 – Determination of Gross Farm Income:**

Schedule E	Includes gross farm income from pass-through entities and crop-share arrangements (via Form 4835). It does not include cash rent received on farm land.	Line 41	_____
Schedule F	Gross income	Line 11/52	_____
Form 4797	Portion of gains attributable to the sale of draft, dairy, or breeding stock (see Note 2)	Various	\$ _____
			_____ %

**3 – Determination of Gross Income Ratio:**

Total gross farm income ÷ total gross income = percentage of gross income attributable to farming. Must be at least two-thirds (66.67%) to qualify for the special estimated tax rules for farmers.

*Notes:*

1. See Schedule K-1 for a pass-through entity owner's share of gross farming income or gross nonfarm income.
2. Farm income does not include gains or losses from the sale of farmland and depreciable farm equipment or income from custom farm operators.
3. IRS Publication 225 specifies only capital gains are to be considered, and capital losses cannot be netted against capital gains.

### Special Rules for Farmers' Estimated Taxes

If a qualified farmer receives at least two-thirds of his gross income from farming, estimated tax payments are not required if Form 1040 is filed and any tax due is paid on or before March 1 [Sec. 6654(i)].

*Caution:* State filing requirements may differ from federal requirements.

If a farmer makes an estimated tax payment by January 15, Form 1040 and any balance of tax owed is not due until April 15. The estimate can be either:

- 100% of the previous year tax liability; or
- Two-thirds of the current year tax liability [Sec. 6654(i)(1)].

#### Example 7-3

Keith Renfield, a farmer, meets with his tax advisor to work on year-end tax planning. Keith's 1997 tax liability was \$2,000, but for 1998 Keith's projected tax liability is \$20,000. Keith's tax advisor recommends that Keith make a January 15, 1999 estimate of \$2,000.

Keith can file his 1998 Form 1040 on April 15, 1999, and pay the remaining \$18,000 without penalty.

Time value of money, at 6%, would indicate the following benefit:

\$2,000 × 6% × 1½ months (\$2,000 paid 1/15/99, otherwise not due until 3/1/99)	\$(15)
\$18,000 × 6% × 1½ months (\$18,000 paid 4/15/99 instead of 3/1/99)	<u>135</u>
Net Savings	<u>\$120</u>

*Practice Tip:* Clients and practitioners alike often confuse the March 1 filing and payment privilege of farm taxpayers with the "due date" of their Form 1040. The March 1 deadline only has significance for the Form 2210 individual tax underpayment penalty; it does not change the reference point of an April 15 due date for other statutory purposes. Accordingly, a farmer filing by March 1, nevertheless has until April 15 to complete an IRA or Keogh investment.

## SOCIAL SECURITY EARNINGS AND BENEFIT COMPUTATION

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### Background

With the rising cost of Social Security due to increasing rates and base income levels, monitoring and planning for Social Security benefits, whether retirement, survivor or disability benefits, is a valued service which tax practitioners can provide to their clients. Social Security planning should not be limited to clients who are reaching retirement age; clients of all ages benefit from Social Security planning.

### Eligibility for Benefits

Social Security retirement benefits are available to individuals who are fully insured. To qualify for fully insured status, an individual must have sufficient credits. Although credits differ for survivor and disability benefits, the following table lists the credits required to be fully insured for retirement benefits:

<u>Year of Birth</u>	<u>Credits to be fully insured</u>
1921	32
1922	33
1923	34
1924	35
1925	36
1926	37
1927	38
1928	39
1929 and after	40

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Credits are received for earnings (wages or self-employment income) in excess of amounts established by the Social Security Administration. For 1998, quarterly earnings must exceed \$700 to obtain each credit. Upon meeting the required number of quarters to be fully insured, an individual is covered for life.

### Survivor Benefits

For a child or spouse to receive survivor benefits, an individual age 28 or younger must have a minimum of six social security credits. For every year over age 28, the minimum increases by 1 credit. For 1998, it takes \$700 of wages to earn a quarter of work credit, or \$2,800, annual wages to earn four social security credits.

*Practice Tip:* Married farm proprietors with younger children should consider paying their spouse, who does not have an outside job, an annual cash wage to build up a social security earnings history for survivor benefits.

### **Benefit Computation**

The earnings base is used to calculate retirement benefits. For a taxpayer born in 1929 and after, the highest 35 years are used for the earnings base. For each year of birth before 1929, the number of years is one less (e.g. born in 1926 = 32 year earnings base).

### **Benefits Available**

A fully insured individual and his spouse/dependents are eligible for the following benefits:

- Reduced retirement benefits for the worker at age 62 or older; full retirement benefits for the worker at age 65 (starting in the year 2000, the full retirement age will be increased in monthly steps until it reaches age 67 in 2027);
- Retirement benefits for the worker's spouse at age 62 or older;
- Dependent benefits for retired, deceased, or disabled worker's spouse if maintaining care of a child under age 16 or disabled;
- Dependent benefits for unmarried children under age 18 of a retired, deceased, or disabled worker. If the child is a full-time elementary or high school student, the age limit is 19;
- Survivor's benefits for a widow(er) of a worker upon reaching age 60;
- Survivor's benefits for a disabled widow(er) upon reaching age 50; and
- Survivor's benefits for a dependent parent of a deceased worker.

A divorced spouse may be eligible for the above-mentioned benefits if married at least 10 years to the worker and divorced from the worker at least 2 years prior to receiving benefits. If the divorced spouse remarries before reaching age 60, the benefits are lost unless divorced again.

Social Security benefits can be computed if the worker's date of birth, date of retirement and year-by-year earnings history are available.

A computer program is available which produces the Social Security primary insurance amount (PIA) for an old age, survivor, or disability benefit. The program is written for the IBM PC and compatibles. The disk and user guide can be ordered for a nominal fee from:

National Technical Information Service  
5285 Port Royal Road  
Springfield, VA 22161  
(703)487-4650

The program is menu-driven and automates the normally lengthy hand computation. The program does have some limitations compared to the Social Security Administration online program, but it does have the ability to: (1) save cases on the disk to be rerun later, (2) print a large amount of detailed output, (3) enter assumptions as to future benefit increases and average wages, (4) be run on a stand-alone personal computer, and (5) produce a benefit estimate.

The information needed to run the program includes basic taxpayer information such as date of birth, retirement date and age, type of benefit to be calculated and earnings history. The earnings history must be earnings per year. This can be requested on Form SSA-7004-PC-OP2(9/89). This form is Exhibit 7-2 at the end of the chapter, and can be obtained from any local Social Security office.

In addition to a detailed yearly earnings history, the SSA also sends (in response to Form SSA-7004) a print of estimated retirement benefits at age 62, 65 (or over, depending upon year of retirement) and 70, estimated survivors benefits, and estimated disability benefits.

The software program is updated by the Social Security Administration for cost of living adjustments.

*Practice Tip:* Calculations can be completed to determine if it is economical to report higher self-employed Social Security earnings to increase the earnings base. As an example, by adding \$10,000 to pre-retirement earnings, an annual increase of *about* \$50 in Social Security benefits results. The self-employment tax on \$10,000 is \$1,413 ( $\$10,000 \times 92.35\% \times 15.3\%$ ).

This equates to *about* a 3.5% annual return on investment. Spousal benefits at half the working spouse benefit amount increase the return to around 5%.

### **Useful Precaution**

Form SSA-7004-SM (2/93), Request for Earnings and Benefit Estimate Statement, should be submitted periodically to verify the accuracy of the posting of earnings to an individual's account. If errors are found, a letter should be sent to the SSA along with proof of the correct wages (copy of Form W-2) or self-employment income (copy of Form SE).

Technically, changes to an individual's earnings record must be made within 3 years, 3 months and 15 days of the year-end affected; however, the SSA has the authority to change a record beyond this time frame under certain circumstances, such as failure to post a W-2.

### **Earnings Limitations for Social Security Recipients**

An earnings limitation applies until age 70 if a retired worker continues to work after reaching retirement age and beginning benefits. If the worker earns more than the earnings limitation, his or her benefits and dependent benefits will be reduced. The benefits reduction is \$1 for every \$2 if under age 65 or \$1 for every \$3 if age 65-70.

The earnings limitations for 1998 were as follows:

<u>Age</u>	<u>1998 Limits</u>
under age 65	\$ 9,120
age 65-69	14,500

The earnings limitation is based on annual earnings. There is no limit on the amount that can be earned in any month except in the year of retirement. If the farmer continues to work in the year of retirement after benefits start, benefits can be reduced for any month substantial services are performed and earnings exceed the monthly exempt amount for that year.

**Carryover Crop Exclusion Provisions.** Carryover crop is grain grown and harvested prior to retirement. Carryover crop may be marketed any time after retirement without risk of exceeding the earnings limitation. Upon retirement, the farmer must advise his social security representative of the amount of carryover grain on hand.

#### **Example 7-4**

Alex Winters turned age 65 in November, 1997. When he retired in November, he had 20,000 bushels of corn on hand, all of which was harvested prior to November, 1997. Alex begins Social Security retirement benefits for January, 1998.

When Alex sells his carryover crop, the income will not be included in the earnings limitation test, however, Alex must report the income on Schedule F so that it is subject to self-employment tax.

**Compliance Requirement.** Form SSA-777-BK, Annual Report of Earnings, is required to be filed by the following individuals no later than April 15 of each year:

- Retirees whose earnings exceed the annual earnings exclusion limit;
- Retirees who had their monthly benefits reduced because they expected to earn more than the annual earnings exclusion limit. If actual earnings are under the limit, the annual report must be filed; or
- Retirees for whom the monthly earnings limit applies.

## **STAGGERING OF ITEMIZED DEDUCTIONS**

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### **How It Works**

Almost all individuals are on the cash method of accounting with regard to their personal itemized deductions. Planning the time for payment of a few key deductions allowable as itemized deductions on Schedule A can be a significant tax planning tool.



Many farmers are using the standard deduction as opposed to itemizing their deductions due to the following factors:

- Increased standard deduction;
- Nondeductibility of personal interest expense;
- 7.5% medical floor and 2% miscellaneous deduction floor;
- Payment of contributions in commodities (see Chapter 4);
- Deductibility of medical expenses on Schedule F vs. Schedule A due to spousal employee benefit plan (see Chapter 4); and
- Home mortgage interest and real estate taxes may not be as high as most urban taxpayers.

Farmers can take advantage of itemized deductions by staggering and “doubling up” itemized deductions in one year to exceed the standard deduction, and thereby having very few of these expenses in the following year allowing the use of the standard deduction.

#### **Example 7-5**

Howard, a farm proprietor, files a joint tax return with his spouse. Howard has annually been incurring about \$5,000 of state income tax and charitable contributions and has been unable to itemize due to the larger standard deduction. Howard's tax advisor suggests prepayment and staggering of itemized deductions.

*(Text continued on page 242)*

The following depicts the benefits of staggering expenses:

	(Staggered)		(Do Not Stagger)	
	1998	1999	1998	1999
AGI	\$40,000	\$40,000	\$40,000	\$40,000
Exemptions	(5,400)	(5,400)	(5,400)	(5,400)
Itemized deductions				
• 1997 state tax paid 3/2/98	(3,600)	—	—	—
• 1998 state tax paid 12/31/98	(4,000)	—	—	—
• 1998 contributions	(1,000)			
• 1999 contributions (Paid by 12/31/98)	(1,000)			
Standard deduction	—	(7,100)	(7,100)	(7,100)
Taxable Income	\$25,000	\$27,500	\$27,500	\$27,500
Combined (98 & 99) taxable income	\$52,500			\$55,000
Decrease in taxable income by doubling up				<u>\$2,500</u>

*Note:* For this example, 1999 personal exemptions and standard deduction are assumed the same as 1998.

### State Income Tax Prepayments—Caveats

The prepayment of state income taxes is not always beneficial to a taxpayer if the taxpayer consistently itemizes deductions year after year. With the lower tax rates, the benefit from current federal tax savings does not always exceed the present value of the cash outlay; however, the following exceptions exist in favor of prepayment of 1998 state income taxes in December 1998:

- Alternative minimum tax may be triggered in 1999 due to the mixture of income and deductions;
- Standard deduction in 1999 vs. itemized deductions in 1998;
- If quarterly estimates are required for 1999, prepayment may lower 1998 tax on which to base 1999 estimates (prepayment helps the time value of money by reducing estimates); and

- Farmers filing March 1, as opposed to April 15, brings the time when the final payment would be due closer to the December 31 prepayment.

## EFFECTIVE USE OF TAX BRACKETS

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### Maximizing Income Within Brackets

Establishing income targets at the top of the various income tax brackets is a key element of effective tax planning. For cash basis farmers, planning the effective use of tax brackets can be accomplished through preyear-end calculations.

The 1998 joint federal tax brackets are as follows:

<u>Taxable Income</u>	<u>Federal Tax Rate</u>
\$ 0–\$42,350	15%
\$42,351–\$102,300	28%
\$102,301–\$155,950	31%
\$155,951–\$278,450	36%
Over \$278,450	39.6%

Generally, tax practitioners target taxable income either to the top of the 15% or 28% tax brackets. If a farmer is below the top of a tax bracket, the tax practitioner may work with the farmer to determine whether to sell additional commodities or defer expenses so as to raise taxable income.

If the farmer is just into a higher tax bracket, it may be advisable to incur additional expenses to bring down taxable income to the next bracket.

The increasing self-employment tax rate makes tax planning even more complex. Not only do tax practitioners need to watch the taxable income brackets, but they also need to be aware of the self-employment tax base. Fluctuating income levels may result in less income and self-employment taxes than if income is kept level. The following example compares total tax for fluctuating income vs. level income.

**Example 7-6**

Filbert is a farm proprietor who carefully plans his joint taxable income to remain level at \$50,000 per year. Because Filbert already has a strong Social Security earnings history built up, his tax advisor suggests that he stagger his income so as to have one large income year about every three years.

**Level Income Method**

	Year 1	Year 2	Year 3
Taxable Income (\$150,000 over 3 years)	<u>\$50,000</u>	<u>\$50,000</u>	<u>\$50,000</u>
Income Tax (Joint)	\$ 8,502	\$ 8,502	\$ 8,502
Self-employment tax	7,065	7,065	7,065
Total		<u>\$46,701</u>	

**Fluctuating Income Method**

Taxable Income (\$150,000 over 3 years)	<u>\$35,000</u>	<u>\$80,000</u>	<u>\$35,000</u>
Income Tax (Joint)	\$ 5,250	\$16,902	\$ 5,250
Self-employment Tax	4,945	10,758	4,945
Total		<u>\$48,050</u>	
Tax Savings		<u>\$ 1,349</u>	

The fluctuating method saves tax when self-employment income is above the self-employment income base (\$68,400 for 1998).

The fluctuating method may not be advantageous when income is lower, and it may also result in lower Social Security benefits in the future.

**Example 7-7**

Assume the same facts as the preceding example, except that Filbert's income averages \$35,000 per year.

<b>Level Income Method</b>	<b>Year 1</b>	<b>Year 2</b>	<b>Year 3</b>
Taxable Income (\$105,000 over 3 years)	<u>\$35,000</u>	<u>\$35,000</u>	<u>\$35,000</u>
Income Tax (Joint)	\$ 5,250	\$ 5,250	\$ 5,250
Self-employment Tax	4,945	4,945	4,945
Total		<u>\$30,585</u>	
 <b>Fluctuating Income Method</b>			
Taxable Income (\$105,000 over 3 years)	<u>\$20,000</u>	<u>\$65,000</u>	<u>\$20,000</u>
Income Tax (Joint)	\$ 3,000	\$12,702	\$ 3,000
Self-employment tax	2,826	9,608	2,826
Total		<u>\$33,962</u>	
Additional Tax		<u>\$ 3,377</u>	

**Consider Combined Rates**

When doing tax planning it is important to consider overall combined rates (including state tax rate). It is not as simple as assuming higher income means a higher tax bracket.

Following is a chart of the various combined federal tax rates for 1998, joint status:

Federal income tax	15.0%	28.0%	31.0%	31.0%	36.0%	39.6%
Self-employment tax	<u>15.3%</u>	<u>15.3%</u>	<u>15.3%</u>	<u>2.9%</u>	<u>2.9%</u>	<u>2.9%</u>
Total	<u>30.3%</u>	<u>43.3%</u>	<u>46.3%</u>	<u>33.9%</u>	<u>38.9%</u>	<u>42.5%</u>

*Practice Tip:* If a taxpayer is consistently in the 43.3% or 46.3% combined marginal tax brackets, it may be advantageous to let the taxable income rise above the self-employment tax base and into the 31% federal income tax bracket for one year to clean up carryover crop and/or to get away from excessive year-end prepaid expenses.

This may be particularly attractive to a farmer just prior to retirement. Additional self-employment tax paid at this time may not significantly increase retirement benefits. This strategy may also assure that future years' income can be brought below high tax brackets.

*Practice Tips:* Tax practitioners should monitor carryover crops and prepaid expenses of their cash-method farmers as a part of tax planning with their clients. Monitoring the carryover crops

will allow the tax practitioner to observe trends of increasing inventory levels, and properly advise the cash method farmer on the proper level of taxable income to report.

Similarly, prepaid expenses should be monitored. If a farmer is continually prepaying farm expenses, he may be limited to their deduction due to the 50% prepaid expense rule (see Chapter 2).

### **Management Information**

Profits, as reflected on tax returns using the cash method, may not provide a good source for management information. Schedule F farm income does not give a true picture of current year results because:

- Most farmers use the cash basis of accounting;
- Therefore, inventories are not accounted for;
- Many expenses may be prepaid; and
- Income is generally targeted based on tax brackets, with irregular amounts recognized from year to year.

For management decisions, it may be necessary for farmers to keep separate books on the accrual basis to determine actual production for any given period. Inventories, prepaid expenses, receivables and payables must be factored in to calculate actual results.

Financial analysis is enhanced through the use of departmentalized financial statements. Each enterprise, whether grain or livestock, can be analyzed to determine production and profit.

## EXHIBIT 7-1

### VARIOUS ATTRIBUTES OF IRAs, SEPs and KEOGH PLANS

ATTRIBUTE	IRA	SEP	Keogh
Contribution Limits	Lesser of \$2,000 (\$4,000 for spousal IRA starting in 1997) or earned income. Subject to limitations if participant in qualified plan	Up to 15% of employee wages (limited to \$160,000) or self-employed net business income; \$30,000 maximum	Money purchase plan-up to 25% of employee wages (limited to \$160,000) or self-employed net business income; Profit sharing plan—substitute 15% for 25%; \$30,000 maximum for both
Deadline for setting up plan	Due date of return	Due date of return—including extensions	Last day of tax year
Deadline for contributions	Due date of return not including extensions	Due date of return—including extensions	Calendar year—3½ months after year-end; fiscal year—½ months after year-end; including extension.
Eligibility requirements (can be less than specified in each column)	None	—Employed 3 of last 5 years —21 years of age —Income level varies for each year for participation (\$400 in 1997)	May be less but cannot exceed: —Employed at least 1 yr., 2 yrs. if 100% vesting. —21 years of age —1,000 hrs. per year of employment
Withdrawals from plan before 59½ & not due to death, divorce or disability	Distributions subject to ordinary income taxes & IRS 10% penalty	Distributions subject to ordinary income taxes & IRS 10% penalty	Distributions subject to ordinary income taxes & IRS 10% penalty

EXHIBIT 7-2

REQUEST FOR EARNINGS AND BENEFITS ESTIMATE STATEMENT AND REPLY

SOCIAL SECURITY ADMINISTRATION

Form Approved OMB No. 0950-0466 SP

Request for Earnings and Benefit Estimate Statement

To receive a free statement of your earnings covered by Social Security and your estimated future benefits, all you need to do is fill out this form. Please print or type your answers. When you have completed the form, fold it and mail it to us.

1. Name shown on your Social Security card:

First Name Middle Initial Last Name Only

2. Your Social Security number as shown on your card:

SSN grid

3. Your date of birth

Month Day Year

4. Other Social Security numbers you have used:

Other SSN grids

5. Your sex: Male Female

6. Other names you have used (including a maiden name):

Other names line

7. Show your actual earnings for last year and your estimated earnings for this year. Include only wages and/or net self-employment income covered by Social Security.

A. Last year's actual earnings: (Dollars Only) \$ grid

B. This year's estimated earnings: (Dollars Only) \$ grid

8. Show the age at which you plan to retire:

Age grid (Show only one age)

9. Below, show the average yearly amount you think you will earn between now and when you plan to retire. We will add your estimate of future earnings to those earnings already on our records to give you the best possible estimate.

Enter a yearly average, not your total future lifetime earnings. Only show earnings covered by Social Security. Do not add cost-of-living, performance or scheduled pay increases or bonuses. The reason for this is that we estimate retirement benefits in today's dollars, but adjust them to account for average wage growth in the national economy.

However, if you expect to earn significantly more or less in the future due to promotions, job changes, part-time work, or an absence from the work force, enter the amount in today's dollars that most closely reflects your future average yearly earnings.

Most people should enter the same amount they are earning now (the amount in 7B).

Future average yearly earnings: (Dollars Only)

Future average yearly earnings \$ grid

10. Address where you want us to send the statement.

Name

Street Address (Include Apt. No., P.O. Box, or Rural Route)

City State Zip Code

11. Please check this box if you want to get your statement in Spanish instead of English.

I am asking for information about my own Social Security record or the record of a person I am authorized to represent. I understand that if I deliberately request information under false pretenses I may be guilty of a federal crime and could be fined and/or imprisoned. I authorize you to use a contractor to send the statement of earnings and benefit estimates to the person named in item 10.

Signature box with fields for Signature, Date, and (Area Code) Daytime Telephone No.



Exh 7-2 continued

FACTS, CREDITS, AND EARNINGS

YOUR EARNINGS RECORD

May 6, 1992

THE FACTS YOU GAVE US

Your Name .....  
 Your Social Security Number .....  
 Your Date of Birth ..... August 31, 1959  
 1991 Earnings ..... \$ 7,772  
 1992 Earnings ..... \$10,000  
 Your Estimated Future Average Yearly Earnings ..... \$20,000  
 The Age You Plan To Retire ..... 65  
 Other Social Security Numbers You've Used ..... None

We used the facts you gave us and the information in our records under your Social Security number to prepare this statement for you.

When we estimated your benefits, we included any 1991 and 1992 earnings and any future estimated earnings you told us about. If you did not estimate your future earnings, we did not project any future earnings for you.

YOUR SOCIAL SECURITY CREDITS

To qualify for Social Security benefits and Medicare, you need credit for a certain amount of work covered by Social Security. The number of credits you need will vary with the type of benefit. Under current law, you do not need more than 40 credits to qualify for any benefit or for Medicare.

Our review of your earnings, including any 1991 and 1992 earnings you told us about, shows that you now have at least 40 Social Security credits.

YOUR SOCIAL SECURITY EARNINGS

The chart on the next page shows the earnings on your Social Security record. It also estimates the amount of Social Security taxes you paid in each year to finance benefits under Social Security and Medicare. If you have government earnings that help you qualify for Medicare, those earnings also are included on the chart under the heading "Medicare—Your Taxed Earnings."

We show earnings only up to the maximum yearly amount covered by Social Security. These maximum amounts are shown on the chart. The chart may not include some or all of your earnings from last year because they may not have been added to your record yet.

YEARS	SOCIAL SECURITY			MEDICARE	
	Maximum Yearly Earnings	Year Taxed Earnings	Estimated Taxes You Paid	Year Taxed Earnings*	Estimated Taxes You Paid
1937-50	\$3,000	\$ 0	\$ 0		
1951	3,600	0	0		
1952	3,600	0	0		
1953	3,600	0	0		
1954	3,600	0	0		
1955	4,200	0	0		
1956	4,200	0	0		
1957	4,200	0	0		
1958	4,200	0	0		
1959	4,800	0	0		
1960	4,800	0	0		
1961	4,800	0	0		
1962	4,800	0	0		
1963	4,800	0	0		
1964	4,800	0	0		
1965	4,800	0	0		
1966	6,600	0	0	\$ 0	\$ 0
1967	6,600	0	0	0	0
1968	7,800	0	0	0	0
1969	7,800	0	0	0	0
1970	7,800	0	0	0	0
1971	7,800	0	0	0	0
1972	9,000	0	0	0	0
1973	10,800	0	0	0	0
1974	13,200	0	0	0	0
1975	14,100	157	7	157	7
1976	15,300	0	0	0	0
1977	16,500	402	19	402	3
1978	17,700	427	21	427	4
1979	22,900	1,785	90	1,785	18
1980	25,900	1,284	65	1,284	13
1981	29,700	5,622	300	5,622	73
1982	32,400	12,119	654	12,119	157
1983	35,700	15,465	835	15,465	201
1984	37,800	3,710	200	3,710	48
1985	39,600	572	32	572	7
1986	42,000	612	34	612	8
1987	43,800	6,045	568	6,045	175
1988	45,000	9,257	561	9,257	134
1989	48,000	16,313	988	16,313	236
1990	51,300	0	0	0	0
1991	53,400	Not Yet Recorded			
1992	55,500	Not Yet Recorded			

\* Earnings were taxed for Medicare beginning in 1966. From 1983 on, these earnings include Medicare-Qualified Government Earnings (see page 7). In 1991, the maximum yearly earnings taxed for Medicare are \$125,000. For 1992, the amount is \$130,200.

Exh 7-2 continued

ESTIMATED BENEFITS

**Retirement**

You must have 40 Social Security credits to qualify for retirement benefits. This is the same number of credits you need to qualify for Medicare at age 65. Assuming that you meet all the requirements, here are estimates of your retirement benefits based on your past and any projected earnings. The estimates are in today's dollars, but adjusted to account for average wage growth in the national economy.

If you retire at 65, your monthly benefit in today's dollars will be about..... \$ 845

The earliest age at which you can receive an unreduced retirement benefit is 66 and 10 months. We call this your full retirement age. If you wait until that age to receive benefits, your monthly benefit in today's dollars will be about ..... \$ 975

If you wait until you are 70 to receive benefits, your monthly benefit in today's dollars will be about ..... \$ 1,225

**Survivors**

If you have a family, you must have 11 Social Security credits for certain family members to receive benefits if you were to die this year. They may also qualify if you earn 6 credits in the 3 years before your death. The number of credits a person needs to qualify for survivors benefits increases each year until age 62, up to a maximum of 40 credits.

Here is an estimate of the benefits your family could receive if you had enough credits to be insured, they qualified for benefits, and you died this year:

Your child could receive a monthly benefit of about. .... \$ 450

If your child and your surviving spouse who is caring for your child both qualify, they could each receive a monthly benefit of about..... \$ 450

When your surviving spouse reaches full retirement age, he or she could receive a monthly benefit of about ..... \$ 600

If more family members qualify for benefits (other children, for example), the total amount that we could pay your family each month is about ..... \$ 1,025

We may also be able to pay your surviving spouse or children a one-time death benefit of..... \$ 255

**Disability**

Right now, you must have 20 Social Security credits to qualify for disability benefits. And, these credits had to be earned in the 10 year period immediately before you became disabled. If you are blind or received disability benefits in the past, you may need fewer credits. The number of credits a person needs to qualify for disability benefits increases each year until age 62, up to a maximum of 40 credits.

If you were disabled, had enough credits, and met the other requirements for disability benefits, here is an estimate of the benefits you could receive right now:

Your monthly benefit would be about. .... \$ 510

You and your eligible family members could receive up to a monthly total of about..... \$ 765

These estimates may be reduced if you receive workers' compensation or public disability benefits.

**IF YOUR RECORDS DO NOT AGREE WITH OURS**

If your earnings records do not agree with ours, please report this to us right away by calling the 800 number shown below. We can usually help you by phone. When you call, have this statement available along with any W-2 forms, paystips, tax returns or any other proof of your earnings.

**IF YOU HAVE ANY QUESTIONS**

If you have any other questions about this statement, please read the information on the reverse side. If you still have questions, please call 1-800-537-7005.

Social Security considers all calls confidential. We also want to ensure that you receive accurate and courteous service. That is why we may have a second Social Security representative listen to some calls.

