PRICE AND INCOME POLICY*
— by Neil E. Harl**

As with most sectors of the world economy, agriculture in recent years has been a sector of great change. Closed markets are giving way to free trade, open democratic systems with decentralized decision making are gaining ascendancy over despotic regimes, technology is revolutionizing every facet of production and distribution and competition is assuring that consumers everywhere are elevated to a high pedestal faintly reminiscent of the kings of old.

It is assumed that the governing policy goals for the food and agriculture sector will continue to include—(1) availability of an abundant supply of food, at reasonable prices; (2) maintenance or enhancement of the productivity and environmental integrity of natural resources; and (3) a prosperous and productive economic climate for producers (including family farmers).

It has been clear for a decade and a half that the debate on U.S. farm policy has been dominated by agribusiness firms. The outcome has consistently been in accord with the objective of most agribusiness firms of encouraging maximum production of crops. Some have even been moved to observe that U.S. farm policy has been “high-jacked” by those who take a very narrow view of what is expected from the agricultural sector and what should constitute the parameters of farm policy.¹

The expenditure of federal funds, which has reached record levels in recent years in support of federal farm programs, should be subject to the same kind of benefit-cost calculus applied for other federal expenditures and that the outcome of such analysis should help to shape federal farm policy. The fiscal pressures of the country underscore the importance of a rational approach to resource allocation in stabilizing the agricultural sector.

Flaws in the 1996 farm bill

The 1996 farm bill, enacted during a brief period of economic euphoria in 1996, stripped the Secretary of Agriculture of all authority to manage inventories and set the stage for all-out production of the major program crops. From 1938 to 1996, the Secretary had been given authority to act, in effect, as the surrogate CEO of agriculture and to do what every other CEO does when inventories come to be viewed as excessive—idle workers and idle productive capacity. Those authorities were swept away despite overwhelming evidence that agriculture’s capacity to produce has consistently exceeded the capacity of markets to absorb the production without unacceptably low prices.

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The 1996 farm bill represented a significant departure from federal farm legislation since 1933. While the transition away from government programs was expected to produce a more rational system of resource allocation, several important implications of the shift deserve mention.

- The loss of protection against low prices is proving to be a serious problem, as we had feared.

More fundamentally, the question has been whether the Congress would allow the use of price to reduce supply. In October of 1998, Congress passed an economic assistance package totaling $5.975 billion to insulate partially U.S. farmers from the effects of low prices. Legislation providing an even larger assistance package was provided in 1999. These amounts are in addition to AMTA payments, LDP payments, disaster assistance and marketing loan costs. The total outlay was more than $15 billion in 1998, exceeded $22 billion in 1999, rose to $28 billion in 2000 totaled roughly the same in 2001 with prospects for substantial outlays in 2002. A major question facing Congress is what U.S. farm policy will be beyond 2002.

While some sectors of U.S. agriculture enjoyed favorable prices in 1995-96, low prices returned in 1998 with a brief respite in 2002 because of drought conditions. The result of an increase in supply is a disproportionate drop in price—and in profitability. That means consumers have been in a very favorable position, assured of an ample supply of food and fiber at a relatively low cost, long-term. But, it means also that producers periodically endure periods of low prices.

The agricultural sector, in terms of policy, is characterized by two important features:

—First, the number of producers is so great that no single producer can influence price with their output decisions and so they may not cut back on production until price drops below variable costs or they are able to shift to a more profitable alternative crop. This feature makes it difficult for the sector to reduce supply without government assistance.

—Second, although we have become very clever in developing more effective chemicals, better seed varieties, larger and more efficient equipment and improved management, our cleverness still hasn't given us much influence with weather. Year-over-year, weather is the big factor influencing supply of the major crops in this country. Given the enormous capacity to produce, a series of years with favorable weather puts pressure on price. It was to be expected that farm commodity prices will be more volatile than during the era of farm programs. This is important to consumers as well as producers.

- Elimination of the federal farm programs was expected to mean less economic buoyancy from government. However, instead expenditures have risen to record levels.

Under the farm programs from 1933 to 1996, government farm programs attempted to help balance demand and supply by idling land. Depending upon the year, the amount of idled land ranged from none to 70 to 80 million acres. The land was idled in checkerboard fashion, some of the very best land was idled and some of the poorest. This was not economically rational but it spread the burden of adjustment over the entire country and it did not squeeze producers economically as adjustments were made in the productive base.
Under the 1996 legislation, production decisions in theory were left to the market. And the market doesn't adjust production in the same way as government programs. The market squeezes out the thinner soils and steeper slopes, the higher per-unit cost of production areas. With no land idled, production increases, crop prices fall, and land values come under pressure until there is less profitability for crop production on the least productive land than for the next most profitable use for that land. The least productive land then transitions out of intertillled crops to a less intensive use, to another crop or to grazing land. Depending upon the area, some might transition to wasteland. At least, the increase in supply of grazing land would assure that the less productive grazing land would decline in value.

Rather than having 70 to 80 million acres of farm land out of production on a checkerboard-pattern, it was anticipated that close to that many acres would transition to a lower-valued use unless exports were maintained at high and rising levels. However, the more productive land would not be among those acres moving to a lower-valued use. The transition would tend to be concentrated in areas with highly erodible, lower productivity land that has thinner soils and lower rainfall.

This movement of land to a less intensive use spells economic pain for producers everywhere. Adjustment pain is felt not just by those at the periphery of the core producing areas, but by producers everywhere. Beyond that, those geared up to sell inputs to or purchase outputs from a crop-based agriculture also would have to adjust.

After a period of adjustment, the economic returns to labor and capital (unlike returns to land) will likely return to an equilibrium level.

Figure 2 illustrates the fact that, for each major crop, under such policies there would be a “core” area of production and a “swing zone” at the periphery.

That zone of thinner soils and steeper slopes at the periphery of major crop producing areas becomes a swing factor in production. In times of good prices, it swings back into intensive production; when prices fall, it’s squeezed out again. This is the reason now why the most intensive resistance to the 1996 farm bill is in those swing areas where the next best use represents an economic jolt for producers and others involved. And it means another dimension of instability for those areas.

So, while the market is doing its job, the squeeze is felt even by those on the best, most productive, soils as the production of the major crops shrinks into a more compact area with 100 percent of the best land in production.

These land use shifts aren't likely to be one-time events. As exports rise (or fall), domestic demand rises (or falls) and changes in supply from technology and weather occur, the zone of swing acreage at the periphery of the core areas will see shifts in land use occur. All of this is rational, economically, but it adds enormous uncertainty for producers; those who supply inputs; and those who store, ship, dry or process outputs.

The implicit mechanism in the 1996 farm bill to adjust production in the face of low prices was economic pain. It should be abundantly clear, by now, that Congress does not like models of adjustment based on economic pain. That is precisely what the 1996 farm bill was
designed to do—adjust output by inflicting economic pain on producers. The wheels fell off that wagon at the first turn, with low prices in 1998. Even though Congress voted, by a narrow margin, to enact the 1996 farm bill, by an even larger margin the Congress has cheerfully provided massive cash infusions since, in 1998, 1999, 2000 and 2001 and the Congress is expected to deliver yet another generous amount of cash in 2002. Perhaps to save face, Congress has been willing to do that rather than to face up to the inherent shortcomings in the 1996 legislation. The authors of a recently published policy text acknowledge the flawed nature of the FAIR Act in explaining that, “the 1996 law was an internally inconsistent policy mix, based more on compromise and convenience than on conviction. It led to larger outlays rather than smaller government outlays for agriculture and was market oriented for some crops but not others.”

That passage would suggest that the authors may be in agreement with this commentator who has stated publicly on more than one occasion that the 1996 farm bill was the second most irresponsible Congressional act in the twentieth century. The authors of that text rail at distortions from 1933 to 1996 but say little about the distortions of huge amounts of cash into the farm sector, much of which has been capitalized into, or propped up, cash rents and land

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values and dropped the cost of feed and other commodities to purchasers, in some instances to levels well below the cost of production.

**Choices in farm policy**

*Three choices.* Congress faces three choices on how to proceed in the face of low commodity prices, high levels of budget outlays at the federal level and continuing economic problems on the part of producers.

- One possibility is to continue the heavy subsidization that has become the hallmark of the 1996 farm bill for the “program” crops. While the $28 billion plus for the 1999-2000 federal fiscal year was a modest fraction of the country’s food bill, as was $32 billion in 2000-2001, those figures are large enough to be visible budgetary targets.

  If the country is in an economic downturn, as is the case, that level of expenditure looms even larger. With the budget surplus narrowing, or even disappearing, less money is sloshing around Washington and additional appropriations for agriculture may be more difficult to obtain. Indeed, there is a possibility that agriculture will not receive the funding authorized in the 2002 farm bill. The terrorist attacks on September 11 have assured that substantial amounts of resources will be devoted to repairing that damage and protecting against future attacks. Moreover, those attacks have weakened consumer confidence which has deepened the economic downturn. All of these factors suggest that agriculture’s rations are likely to be less.

  It appears virtually certain that the level of subsidy of the agricultural sector received in recent years will be unattainable on a long-term basis.

- Another hazard is a change in priorities in the budgetary process with a majority in Congress concluding that other programs merit more funding and agriculture less in support. Again, the terrorist attacks have consumed the attention of the Congress which has dropped agriculture’s priority position to a lower level.

  A second possibility would be to reduce—or eliminate—federal subsidies for agriculture. That would likely result in a reduction in land values. Much of the subsidies is being bid into cash rents and capitalized into land values. One cannot justify present land values on the basis of existing commodity prices. If investors were to develop an expectation of less federal funding—or none at all—land values would likely decline. The drop would be severe if withdrawal of subsidies is abrupt. After all, land values are based heavily on expected profitability of the dominant crops in the area plus expected government payments.

  Some have argued for a withdrawal of all subsidies with land values falling to a new lower level. Equilibrium would eventually be re-established for returns to labor and capital near present levels. But returns to land would almost certainly be re-established at lower levels on a more or less permanent basis. While that might be appealing to some, the ride down would be rough.

  Yet, the awesome part of this is the growing vulnerability of the sector to just such an adjustment. 
Even with the sharp declines in land values, pressure on prices would continue as supply fluctuates but with technology likely pushing the supply curve to the right faster than demand is likely to increase.

Those who point to high land values as a factor in international competitiveness are wide of the mark, however. It’s been clear since repeal of the corn laws in Britain more than a century and a half ago that land values are price determined, not price determining. Land values are not properly viewed as a cost of production but as the result of expected profitability. Producers in every country are expected to bid profitability into cash rents and capitalize the amounts into land values. Land values in the United States are influenced by—(1) expected crop profitability, (2) the anticipated level of government payments and (3) other factors including development pressure. Thus, higher land values in the United States than in Brazil should not be viewed as a problem. What will drive down land values is a decline in expected profitability.

Warnken\(^3\) has discussed the factors affecting soybean development in Brazil and does not mention U.S. farm policy. He does list, as important factors, the 1973 U.S. soybean embargo, the fact that acclimated soybean varieties were made available by the U.S., the training of soybean breeders and other scientists in the U.S., the massive government allocation of capital and credit to the soybean sector (estimated at $4 billion from 1970-1990), input subsidies, tax breaks, including the lifting of taxes on exports and guaranteed minimum price policies.

Thus it is believed that modest steps to address the downside of commodity prices are not likely to have much effect on production in South America. Indeed, the amount of land brought into production in Brazil from 1996-2000 (a period of lower world price for soybeans) was greater than from 1992-1996 (when soybean prices were higher).

- The third possibility is to return to the Secretary of Agriculture some of the authorities swept away in the brief period of economic euphoria in 1995-1996. That would enable the Secretary to act as the surrogate CEO of agriculture and to manage inventories as other CEOs do. Many companies occasionally experience excess inventories—Deere, Intel, Boeing, General Motors, indeed virtually every firm in the world. The time honored solution is to idle people and idle productive capacity.

If that is the direction the country takes in its farm policy, the programs should be designed to encourage resource idling at the periphery and to do so in a market-oriented manner. Programs should take into account the clear trend for technology to boost supply faster than demand is likely to increase.

Variable-term land idling (from as short as three years up to 20 years) designed to be particularly attractive in marginal production areas in the so-called periphery or "swing zones" is one possible shift in policy. The "swing zones" are the regions that are expected to be squeezed out of intensive crop production in times of low prices but get back into production when prices recover. Long-term land idling could help ease the economic and social costs of adjustment in those areas. It would mean reduced sales of fertilizer, chemicals, seed and machinery and so it would impact the communities. But those communities are hurting now and will suffer from the

periodic market adjustments that will characterize their economic life from now on. The contracts could be set to terminate if prices rise above a specified level. Another alternative would be to allow farmers to bid land out of production on an annual basis with the reward of a higher loan rate on the rest of the farmer's production. That option would be market-oriented and, under one proposal, would give farmers an option of idling up to 30 percent of their corn, soybean, wheat, cotton or rice acreage. For corn, soybeans and wheat, each one-percent set aside would be rewarded with a one percent loan rate increase. An analysis by the Food and Agricultural Policy Research Institute indicates that the program would boost farm income by $5.4 billion per year at a budget cost of $2.5 billion.

While there was strong and growing support for additional conservation funding in the 2002 farm bill, it is important to maintain a reasonable balance between commodity programs and conservation programs. Tilting too far in favor of conservation would likely result in an increase in value of highly erodible land and a drop in value for the least erodible (or otherwise environmentally vulnerable) land as federal subsidies are likely to be promptly capitalized into land values (or reductions in payments result in decapitalization).

The fiscal realities of the country suggest strongly that stabilization of the agricultural sector will have to be accomplished with less federal subsidization. That will have to be accomplished with resource idling to reduce supply. Once that is in place, the available funds must be administered with a firm cap on payments if public support for the program is to be assured.

The 2002 farm bill

The 2002 farm bill, the “Farm Security and Rural Investment Act of 2002,” was signed into law on May 13, 2002. The legislation largely continues the pattern of all-out production and maximum planting flexibility from the 1996 FAIR Act. As shown in Table 2, the legislation sets the loan rates for corn at $1.98 ($1.95 for 2004-2007), soybeans at $5.00 (the same after 2003) and wheat at $2.80 ($2.75 after 2003). In addition to the loan rate (which is used to determine loan deficiency payments or marketing assistance loans), the legislation provides for a direct

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The author is indebted to Craig Blindert, Salem, South Dakota, and Phil Cyre, Hazel, South Dakota, for development of the "flexible fallow" program.
payment for each of the program crops annually and a counter-cyclical payment which is the
difference between the loan rate plus the direct payment and the target price.  

The 2002 legislation provides for an updating of the crop base for each farm and for an
updating of yields. Both direct and counter-cyclical payments are based on 85 percent of the
base acreage for the farm.

For the dairy program, the Milk Price Support Program is authorized from June 1, 2002
through December 31, 2007, at a rate of $9.90/cwt on a 3.67 percent milk fat basis. In addition,
the legislation establishes a national payment program using a payment formula under which
participating producers will receive monthly payments equal to 45 percent of the difference
between $16.94 and the price per hundredweight of Class I fluid milk in Boston under the
applicable federal milk marketing order. Producers on a “single dairy operation” may receive
payments on no more than 2.4 million pounds of milk marketed per year.

Under the 2002 Act, the total direct and counter-cyclical payments to a “person” for corn,
grain sorghum, barley, oats, wheat, soybeans, minor oilseeds, peanuts, cotton and rice per crop
per year may not exceed $40,000 and $65,000, respectively. The legislation does not impose a
limit on the use of generic commodity certificates (which effectively avoids the payment
limitations).

The 2002 Act also contains a limitation based on “adjusted gross income” which
specifies that an individual or entity is not eligible for any program benefit during a crop year if
the average adjusted gross income of the individual or entity exceeds $2,500,000 unless not less
than 75 percent of the adjusted gross income of the individual or entity is derived from farming,
ranching or forestry operations. The benefits affected by the AGI limitation are direct payments,
counter-cyclical payments, marketing loan gains and conservation.

The 2002 legislation does not contain a ban on packer ownership and control of livestock
but does contain a ban on confidentiality provisions on livestock contracts.

A more rational approach

The apparent trend in thinking in recent years has been to evaluate farm policy solely on
the basis of the cost of food at the farm gate and by the amount of resources utilized in the
production of food and fiber. Regardless of which school of welfare economics one belongs, it
would seem appropriate for policy reform in agriculture to embrace a greater range of policy
objectives at least to the extent the expenditure of public monies is concerned.

For well over a half century, the expenditure of public funds for improvements in
waterways, cancer research, environmental cleanup and numerous other federally-funded project
areas has been subjected to the discipline of a benefit-cost calculus. In general, the benefits and
costs considered have been all of those reasonably stemming from the project. That has not been

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5 For a summary of the Farm Security and Rural Investment Act of 2002, see www.econ.iastate.edu/faculty/harland
and click on “Papers of Interest.”
the case with farm policy. As a consequence, the anticipated impacts on producers, rural communities, the environment, and taxpayers have not been taken into account. Moreover, relatively little effort has been made to provide useful policy-making information as to the impact on consumers in an increasingly concentrated world of input supply and output processing and handling firms.

It is disheartening to see the singular focus on the issue of how to squeeze the costs for commodities to first purchasers to the lowest possible level with no attention whatsoever to the other consequences which are both real and visible. Moreover, when federal funds are involved, as they most certainly are, it seems not only appropriate but essential that funds be expended in such a manner as to produce the greatest possible benefit to the human family. Seventy years ago, flood control projects were selected heavily on political bases. Legislation in 1936 and later has elevated the decision making process to a higher level such that political considerations, although still present, do not dominate the process as was once the case.

The same brand of discipline should be imposed on farm policy. Indeed, there is little reason not to do so. The great surprise is that farm policy has continued to be a highly political process, dominated in recent years by agribusiness firms with huge amounts of cash to influence the policy process. As Schertz and Doering stated, in their recent book, *The Making of the 1996 Farm Act*, a consortium of agribusiness firms amassed a huge war chest to influence the analysis, shape the message and convince members of Congress to support their farm policy agenda.

As the authors stated—

“The idea that farm programs had gone too far in withholding cropland from production was given a substantial boost with the preparation and astute promotion of a study sponsored by the National Grain and Feed Association through their foundation. The study, released in May 1994, concluded that ‘American farmers and the U.S. economy stand to reap substantial benefits from expanding crop area and production.’ Over 185 companies, most of whose profits are geared substantially to volume of commodities handled or processed, were involved in supporting the study prepared by Abel, Daft, & Earley, a consulting firm in the Washington, D.C., area. …

The key conclusion of the study was that 38 million of the then 65 million acres of cropland held out of production at that time under the Acreage Reduction Program (ARP), the Conservation Reserve Program (CRP), and other, but smaller, programs could, under expected demands and yields, be brought back into production between 1994 and 2002 and commodity prices would not be less than they were at the time of the study. Politically, that is a powerful conclusion for there is a strong preference among politicians not to be accused of taking action which leads to lower producer prices. Central to this proposition was the conclusion that demands for U.S. farm commodities would increase enough so that farm commodity prices in the prospective future would not drop below then current levels, even if U.S. farm production increased as hypothesized. The implication for farm income was obvious—more production at the same or higher prices meant more income.”

If a proposed flood control project were to decimate a community, that would be viewed as a project cost. However, if a rural community is diminished economically by the farm bill, or farmers are harmed by the legislation, those costs are ignored and left to be dealt with, if at all,

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by other programs. The result is a dissociation of benefits and costs which distort economic reality. The country deserves better in the area of farm policy just as it deserved better before the landmark 1936 legislation on flood control.

**A global food and agriculture policy**

Farm policy debate in the United States in the 1920s was largely about whether it was appropriate to have a national food and agriculture policy.\(^7\) To a considerable extent, the decision was in the negative until 1933.

In many respects, farm policy today poses a similar question: should efforts be directed toward a global food and agricultural policy? In the opinion of this commentator, the answer is yes.

The globalization of food supply and demand and the position of the United States suggest that food and agriculture policy analysis should shift to a new level to encompass global food and agriculture issues. Such a policy would likely take years to accomplish and would require skillful diplomatic efforts, but the logic behind such an approach to policy is obvious.

A global food and agriculture policy should have several components—

- First, and probably foremost, is support for Third World economic development. With relatively high income elasticities of demand for food (70 percent or more of each additional dollar of income is likely to go for food purchases in some of the countries), it is clear that the last frontier for increasing food demand is the Third World. Moreover, adequate nutrition, worldwide, has the support of a wide array of groups and individuals.

  If the poorest countries could be nudged into the development queue, with investment in education, health care and infrastructure, plus progress in implementing more open and democratic governance systems, the long-pursued goal of elimination of world hunger could be within reach. Gifting food to low income countries, while laudable from a humanitarian point of view, destroys their internal agricultural economy.

- The issue of food safety, including animal diseases as well as genetic modification of foods, should be addressed in a global food policy.

- Food security should be a component of a global policy.

- Fair and equitable sharing of germ plasm should be assured. This could help allay fears of some countries that their germ plasm is being appropriated without compensation by First World countries.

- Trade in agricultural products and commodities is an obvious candidate for inclusion in a global food and agriculture policy as a supplement to negotiated trade agreements.

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• Agreed-upon policies committing major food producing countries to managing excess inventories could be a part of a global food and agriculture policy. Countries would be urged to take action in unison whenever disastrously low food prices occur worldwide with comparable steps taken to reduce food production. The flow of development funds from the United States into the World Bank and IMF and in the form of direct assistance could be used to leverage such responses from other countries.

Export trends


As can be seen in Figure 3, U.S. agricultural exports declined about 40 percent from 1981 to 1986. During that time, corn, soybeans and wheat piled up in storage, in barges on the Mississippi river and up and down main street. Government payments shot above $25 billion in the worst of those years.

After all, as noted above, land values are price determined, not price determining. Land has value as expected profitability is capitalized into the value of land. Some areas of the world can realistically expect significant declines in land values as trade barriers are demolished.

In conclusion

Most farmers and landowners would prefer to make their own production decisions and to produce flat out. That is the first best solution for many.

But the first best solution has produced such budgetary consequences that it is no longer attainable. If that is the case, what is the second best solution? Let land values fall? Or to try managing inventories for a change?
Legal Issues, Part 1*
(Income Tax and Self-Employment Tax)

—by Neil E. Harl**

I. New depreciation rules


1. On March 9, 2002, legislation was signed into law allowing a 30 percent extra depreciation amount for regular tax and AMT purposes. *Job Creation and Worker Assistance Act of 2002, H.R. 3090, § 101.*

   a. Eligible property (original use must commence with the taxpayer).

      (1) Depreciable property with a recovery period of 20 years or less,

      (2) Computer software,

      (3) Water utility property and

      (4) Qualified leasehold property.

   b. The original use must commence with the taxpayer.

      (1) Female animals become used when first placed in use by giving birth to young or giving milk.

      (2) Male animals become used when first used for breeding.

      (3) Casual use is permitted.

      (4) Rebuilt or reconditioned assets are used but investments to recondition or rebuild an asset may be eligible.

   c. With one exception, property subject to alternative depreciation is ineligible for the 30 percent allowance.

      (1) The exception is that the 2002 law makes inapplicable the provision making property subject to an election as to a class of property subject to alternative depreciation.

      (2) Therefore, where a taxpayer has elected to use alternative depreciation, the property should be eligible for the 30 percent allowance.

   d. The depreciation limit for passenger automobiles subject to depreciation limits is increased by up to $4,600 for the first year of depreciation.

   e. The 30 percent limit is claimed after expense method depreciation and before regular depreciation for the year.

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f. The provision in eliminating AMT on property for which the 30 percent deduction can be claimed applies to the property and not just the 30 percent deduction amount.

2. Guidance on claiming the 30 percent depreciation allowance—

a. A taxpayer may make an election not to claim the 30 percent depreciation amount. In the event this election is made, the property is subject to AMT depreciation adjustments for its depreciation life.

(1) If an election is not made to not deduct the 30 percent depreciation for property, it is assumed the 30 percent depreciation is claimed. Thus, the 30 percent depreciation allowance is considered “allowed” or “allowable.”

(2) In general, an election not to deduct the 30 percent depreciation must be made by the due date (including extensions) of the federal income tax return for the year property is placed in service. An automatic extension of six months from the due date of the return (excluding extensions) is allowed for the election not to deduct the 30 percent depreciation if the return was timely filed.

(3) For returns filed before June 1, 2002, the election not to deduct the 30 percent depreciation is considered made if—

(a) The taxpayer made the election by the due date of the return or within the six month extension as required by the Form 4562 instructions (the Form 4562 instructions require a statement indicating the class of property for which the taxpayer is electing not to deduct the 30 percent depreciation allowance), or

(b) Made the election by the due date of the return or within the six month extension and attached a statement to the effect that the taxpayer is not deducting the 30 percent depreciation. A “deemed election” applies if the taxpayer did not claim 30 percent on the return and does not file an amended return to claim the 30 percent depreciation.

(4) For returns filed on or after June 1, 2002, taxpayers not wanting to claim the 30 percent depreciation must make an election not to deduct the depreciation as required by the Form 4562 instructions (attach a statement to the return indicating the class of property for which the taxpayer is electing not to deduct the 30 percent depreciation).

(a) If the original return is timely filed, a taxpayer is allowed an automatic extension of six months from the original due date to make the election (not to deduct the 30 percent depreciation allowance).

(b) Thus, for returns filed on or after June 1, 2002, the taxpayer must either—

[1] Claim the 30 percent depreciation allowance on Form 4562, or

[2] Attach a statement to the income tax return that the taxpayer is electing not to claim the 30 percent depreciation allowance.

(5) An election not to deduct the 30 percent depreciation allowance for a class of property is revocable only with the prior written consent of the Commissioner.

(b) Electing to claim the 30 percent depreciation allowance after filing the return—
(1) If an income tax return was filed before June 1, 2002, and did not claim the additional 30 percent depreciation allowance, but the taxpayer wishes to claim the allowance, the taxpayer can—

(a) File an amended return on or before the due date (excluding extensions) of the return for the next succeeding taxable year. The amended return is to include the statement, “Filed Pursuant to Rev. Proc. 2002-33” at the top of the amended return.

(b) File a Form 3115, Application for Change in Accounting Method, with the taxpayer’s federal tax return for the next succeeding taxable year and pay the tax with that return. The Form 3115 is to be filed in accordance with the automatic change in method of accounting. The Form 3115 should include the statement, “Automatic Change Filed under Rev. Proc. 2002-33.” The deduction is claimed entirely in the year of change.

(c) Do nothing.

3. The property must be acquired after September 10, 2001 (no written contract to acquire before September 11, 2001), and before September 11, 2004, and placed in service before January 1, 2005.

II. Rental of land to a family-owned entity

A. Leasing to a family entity—

1. The lease of property to an entity in which the lessee is also an employee or partner has been held to result in treatment of the lease payments as self-employment income. In a 1995 Tax Court case involving a crop share lease of land to a family farm partnership; the court focused on the “arrangement” which encompassed taxpayer’s involvement as a partner as well as involvement under the lease).

2. IRS has applied the same analysis to rental of land and personal property to a corporation. Three cases were decided by the Tax Court in 1999 in favor of IRS.

3. However, the three cases were reversed on December 29, 2000, by the Eighth Circuit Court of Appeals.

   a. The Eighth Circuit focused on the “nexus” between the lease and the farming operation and stated that “the mere existence of an arrangement requiring and resulting in material participation…does not automatically transform rents received” into self-employment income. The Court pointed out that rents consistent with market rates “very strongly suggest” that the rental arrangement should stand on its own as an independent transaction without self-employment tax being due.

   b. The Tax Court agreed in 2002 that the rents in the three 1999 Tax Court cases were fair market rentals.

   c. Another case has been docketed in the Tax Court which is appealable to the Eighth Court of Appeals.

   d. A case from New York, which is appealable to the Second Circuit Court of Appeals, has also been docketed in the Tax Court.

4. The statute provides as follows—

   “(a) The term “net earnings from self-employment” means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade...
or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member, except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss —

“(1) There shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer; except that the preceding provisions of this paragraph shall not apply to any income derived by the owner or tenant of land if (1) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and (2) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity....”

5 For those not producing agricultural or horticultural commodities, self-employment tax may be imposed when the work is performed by agents.

6 Legislation has been introduced to change “an arrangement” to a “lease agreement.”

7 Short-term solutions (where litigation does not solve the problem)—

a. Convey land to spouse (who is not involved in operation),
b. Transfer land to entity (such as limited partnership or LLC),
c. Pay additional tax,
d. Retire or
e. Die

III. Commodity Credit Corporation loans

A. A farmer may use agricultural commodities as collateral for a loan from the Commodity Credit Corporation (CCC). The loans are nonrecourse so that, at maturity, if the loan plus interest is not paid, the commodity may be forfeited to CCC as full payment for the loan.

B. If the election has not been made to treat CCC loans as income when the loan proceeds are received—

1. The taxpayer has no taxable income until the commodity serving as collateral for the loan is sold or forfeited to CCC as payment for the loan.

2. For the 1983 payment-in-kind (PIK) program, participants who had commodities in storage under CCC loan were asked to give up sufficient amounts of the commodity to equal the taxpayer’s PIK amount.

a. This step created taxable income at that time for taxpayers who had not elected to report the CCC loan as income. Funds received were then used to pay off the CCC loan.

b. As the final step in the process, the commodity was returned to the taxpayer as the taxpayer’s PIK distribution. The distribution was eligible to be treated as though produced by the taxpayer (if the recipient was a “qualified taxpayer”) with the result that taxability was delayed until sold or exchanged in a taxable exchange.
3. For commodity certificates used in 1986 and later years, the certificates should be includible in income upon receipt and with further gain or loss if used to pay down on CCC loans based upon the value of certificate but with no further income tax consequence from reducing a CCC loan treated as loan.

4. Examples of loan cancellation or forgiveness

**Example 1**

A taxpayer, who had always reported income when the crop was sold or forfeited to CCC, obtained a nine month loan on corn on November 20, 1987, for $25,000. The grain was forfeited to CCC in August, 1988. The amount of the loan would be treated as income for 1988.

**Example 2**

If the same taxpayer as in Example (1) obtained the CCC loan on February 15, 1988, and paid off the loan on October 15, 1988, with the corn still owned at the end of 1988, the amount of the loan would not be considered income in 1988.

**Example 3**

If the same taxpayer as in Example (1) obtained a CCC loan on April 1, 1988, paid off the loan on December 1, 1988, and sold the grain on December 15, 1988, the amount of the selling price would be reported as income for 1988.

C. A taxpayer may elect to report CCC loans as income in the taxable year in which the loan is received.

1. The election, once made, applies to all subsequent taxable years unless the taxpayer changes back to treating loans as loans.

   a. Under the regulations, application for permission to change has had to be filed within 90 days after the beginning of the taxable year to be covered by the return. Procedures have been established for taxpayers to receive a 90-day extension of time for applying for a change in method of accounting under Treas. Reg. § 1.77-1. Note that, in general, requests for change in method of accounting may be filed until the due date of the return with an automatic six month’s extension.

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

      (1) The effective date was in error as originally published but corrected effective for tax years ending on or after December 31, 2001.

      (2) The automatic consent procedure generally makes the procedure inapplicable if the taxpayer—

              (a) Is under examination by the Internal Revenue Service or has an issue before an appeals office;

              (b) Is affected by an IRS examination or an appeal before an appeals office;

              (c) Has made the same change in method of accounting or applied for a change in the same method of accounting within the last five years; or

              (d) Would be required to take the entire adjustment resulting from the change in method of accounting in the year of change because it is the final year of the taxpayer’s business.
(3) However, those scope limitations are inapplicable to the revocation on the I.R.C. § 77 election.

c. IRS has ruled that Section 77(a) elections must be made on a return filed on or before the last day of the statutory period, including extensions for filing returns for the taxable year in which the taxpayer first elects to report loans as income.

2. The election to treat CCC loans as income applies to all commodities for that taxpayer. Actually, the election seems to involve reporting as income the value of the crop held as collateral up to the amount of the loan rather than reporting the loan itself as income.

“If a taxpayer elects or has elected...to include in his gross income the amount of a loan from the Commodity Credit Corporation...then—

"(1) No part of the amount realized by the Commodity Credit Corporation upon the sale or other disposition of the commodity pledged for such loan shall be recognized as income to the taxpayer, unless the taxpayer receives an amount in addition to that advanced...as the loan..."

3. The rules on treating CCC loans as income apply only to loans. In a 1961 case, the taxpayer entered into a purchase agreement (in the nature of an option on the part of the farmer) to sell the taxpayer’s 1954 rice crop to the CCC. A loan was obtained in 1954 from a commercial bank using the rice crop as collateral. The crop was sold to CCC under the purchase agreement, with exercise of the option by the taxpayer, in 1955. The court held that the farmer could not elect to include the proceeds of the sale in income in 1954, inasmuch as there was no sale in 1954, and the loan from the bank was not a loan from the CCC.

4. If the election is made to treat CCC loans as income, and the farmer forfeits the crop to CCC, any extra amount received by the CCC on sale of the commodity is income to the taxpayer in the year of receipt by the taxpayer. The excess sales price over the amount previously reported in income is taxable as ordinary income.

5. If the CCC sustains a loss on sale of the commodity, the taxpayer receives no deduction unless held liable for the loss (as noted earlier, CCC loans are generally nonrecourse in nature).

6. The income tax basis of the crop is reduced to the extent of any deficiency with respect to which the taxpayer has been relieved from liability.

7. For loans redeemed the same year, the courts are divided—

(1) The Fifth Court of Appeal held that no income was realized from the loan allocable to a crop that was redeemed in the same taxable year. The court stated:

"§ 77 does not prescribe that the loan is income. It prescribes that it should be ‘considered as income’ and when so done, the method of computing income so adopted shall be adhered to..."

(2) The Ninth Court of Appeal held that the loan is income even though redeemed.

8. If a CCC loan is treated as income and the commodity is redeemed and sold in a later year, the excess above the amount reported into income initially is taxable as ordinary income.

9. As to the timing of income from loans, a loan is income when the funds are received, not when the check is mailed, if the taxpayer is on the cash method of accounting.

10. For commodity certificates in 1986 and later years, income recognition is associated with (1) receipt and (2) disposition, of the certificates, with no further income realized when a CCC loan is reduced. Later disposition of the commodity would produce gain (or loss) depending upon whether the Section 77(a) election had been made.
11. A Section 77 election, once made, applies to all loans in that year.

D. For commodities subject to a “marketing loan,” with the producer repaying the lesser of the CCC loan or the posted county price, be careful that the “marketing gain” is not reported twice.

1. Marketing loans can be repaid at the lesser of principal plus interest or the posted county price.
   a. If the PCP is below the loan rate, it produces a marketing loan gain. In general, that gain must be reported in the year the loan is repaid.
   
   b. There is some support for the argument that taxability of the marketing loan gain can be deferred until the year the commodity is sold for those who have elected to treat CCC loans as income (which gives the commodity a basis as the amount of the commodity equal to the loan amount is reported into income). Deferral is accomplished by reducing the income tax basis for the commodity.

2. Marketing loans are, basically, CCC loans and are subject to the usual rules governing such loans including treatment of such loans as loans or the election to report the loan amount as income.

Example: Agricultural commodities are placed under CCC loan ($500) in 2000. In 2001, the commodity is redeemed when the county posted price is $420. The commodity is sold later in 2001 for $600.

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<th>Without I.R.C. § 77(a) election</th>
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<td>Gain in 2001</td>
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IV. Handling adverse weather problems

A. Crop insurance proceeds

1. Proceeds from insurance, such as from hail or fire coverage on growing crops, are includible in gross income in the year actually or constructively received. In effect, destruction or damage to crops and receipt of insurance proceeds are treated as a “sale” of the crop.

2. Under a special provision, taxpayers on the cash method of accounting may elect to include crop insurance and disaster payments in the taxable year following the crop loss if, under the taxpayer’s practice, income from sale of the crop would have been reported in the later year. Crop insurance and disaster payments must be treated the same if received in the same taxable year.

   a. The election to defer taxability of crop insurance proceeds applies also to disaster payments made under the Agricultural Act of 1949 or title II (pertaining to crop assistance) of the Disaster Assistance Act of 1988. The section was not amended to allow deferral of benefits under the Disaster Assistance Act of 1989 although such an amendment had been proposed. Regulations have been issued permitting deferral despite the statute. For taxable years ending before April 1, 1990, an election to defer crop insurance proceeds was permissible without also deferring disaster benefits.

   b. This includes payments made because of damage to crops and also the inability to plant crops.
(1) The deferral provision applies to federal payments received for drought, flood or “any other natural disaster.”

(2) Under the statute, the inability to plant crops because of a natural disaster is treated as insurance proceeds received as a result of destruction or damage to crops.

(a) This language clearly makes prevented planting payments eligible for the one year deferral.

(b) Does it make such insurance proceeds eligible for involuntary conversion treatment? In a 1959 ruling, a farmer collected insurance on hail damage to the wheat crop. IRS said it was an involuntary conversion and gain could be avoided by investing the insurance proceeds in another crop of standing wheat or a harvested crop. But use of the insurance proceeds to cover the costs of planting a new crop is not the acquisition of eligible replacement property.

c. The election is made by attaching a separate, signed statement to the income tax return for the tax year of damage or destruction or an amended return.

(1) An election counts only for the tax year in which made; application to revoke the election must be made to the District Director.

(2) One election covers the insurance proceeds attributable to all crops representing a trade or business.

(3) The election is made by means of a statement attached to the return (or an amended return) for the taxable year of destruction or damage and is to include the name and address of the taxpayer (or duly authorized representative) along with —

(a) A declaration that the taxpayer is making an election;

(b) Identification of the specific crop or crops destroyed or damaged;

(c) A declaration that under the taxpayer’s normal business practice the income derived from the crops that were destroyed or damaged would have been included in the taxpayer’s gross income for a taxable year following the taxable year of such destruction or damage;

(d) The cause of destruction or damage of crops and the date or dates on which the destruction or damage occurred;

(e) The total amount of payments received from payors (e.g., insurance carriers and government agencies), itemized with respect to each specific crop and with respect to the date each payment was received; and

(f) The name or names of the payor or payors from whom payments were received.

d. A taxpayer may not elect to defer only a portion of the insurance proceeds to the following year. It is not completely clear how one reports insurance and disaster proceeds on a crop normally sold at harvest if other crops are normally carried over, but it would seem that the proceeds of a crop normally sold at harvest could not be deferred.

e. A taxpayer is eligible to defer payments if more than 50 percent of a crop has been carried over historically.
f. Taxpayers in the Klamath Basis area who received payments in 2001 for crops can elect to defer the payments if on the cash method of accounting and the taxpayer can show the crops would have been sold in 2002.

g. Recovery from a feed company’s insurer for contamination of feed resulting in loss of cattle does not come within the statute.

h. Agreements with insurance companies that provide for payments without regard to actual losses of the insured do not constitute insurance payments for the destruction of or damage to crops and do not qualify for deferral.

(1) It is not clear, therefore, whether the deferral provision applies to the newer types of crop insurance such as Crop Revenue Coverage (CRC), Revenue Assurance (RA), Income Protection (IP), Group Risk Plan (GRP), Market Value Protection (MVP), or Replacement Coverage (RC).

(2) Legislation has been introduced to make insurance contracts under the Federal Crop Insurance Act eligible for deferral. The proposed amendment is being revised to allow deferral of revenue insurance payments.

3. The Federal Crop Insurance Corporation, which provides all-risk crop insurance to farmers on a premium payment basis, is required to file an information return with IRS if payments made to a farmer are $600 or more unless the farmer capitalizes expenses and so notifies the FCIC. The same rule applies to hail insurance proceeds.

B. Weather-related sales of livestock

1. One year deferral—

a. Farm and ranch taxpayers on the cash method of accounting who are forced because of drought or other weather-related conditions to dispose of livestock may be able to defer reporting the gain until the following taxable year.

(1) Legislation enacted in 1997 extends the treatment previously available in the event of drought to livestock sold because of weather-related conditions. The amendment is effective for sales and exchanges after December 31, 1996.

(2) To be eligible for deferral, the taxpayer’s principal business must be farming. In a 1989 ruling, a rancher who was grossing an average of $121,000 per year in ranching and earning $65,000 per year in a full-time off-farm job was eligible where the taxpayer devoted 750-1000 hours per year to the ranch and the spouse contributed about 300 hours; the taxpayer’s principal trade or business was deemed to be farming.

(3) The livestock need not be raised or sold in a drought or weather-related area; however, the sale must occur solely on account of conditions in the designated area which affected the water, grazing or other requirements of the livestock so as to necessitate the sale.

(4) Legislation has been introduced to extend the provision to federal land management agency actions.

b. The taxpayer must establish that, under the taxpayer’s usual business practice, the sale or exchange would not have occurred but for the weather conditions; and the conditions must have resulted in the area being designated for assistance by the federal government.
c. Deferral of income is limited to sales in excess of “usual business practices” and, through December 31, 1987, did not apply to livestock held for draft, dairy, breeding or sporting purposes. Since 1987, draft, dairy, breeding, or sporting purpose livestock have been eligible.

d. The election is made by attaching a statement to the income tax return or an amended return for the year in which the early sale of livestock occurs and must be made within the time for filing the return including extensions. Therefore, this election apparently cannot be elected on a late-filed return.

(1) The election must contain—

(a) A declaration that an election is being made.

(b) Evidence of the existence of weather-related conditions which forced the early sale or exchange of the livestock and the date, if known, on which the area was designated as eligible for federal assistance as a result of the conditions. The sale can occur before designation.

(c) A statement explaining the relationship of the area to the taxpayer’s early sale or exchange of the livestock.

(d) The total number of animals sold in each of the three preceding years.

(e) The number of animals which would have been sold in the taxable year had the taxpayer followed its normal business practice.

(f) The total number of animals sold and the number sold on account of weather-related conditions during the taxable year.

(g) A computation of the amount of income to be deferred.

(2) To arrive at the amount of income deferred, the total amount of income from the sale or exchange of livestock in a classification during the taxable year is to be divided by the total number of all livestock sold in that classification. Treas. Reg. § 1.451-7(e)(1). The result is then multiplied by the excess number of livestock sold on account of weather in that classification.

(3) A taxpayer who has made an election to defer the taxation of gain from the sale of livestock because of weather-related conditions may later revoke the election and make an election with the consent of the Commissioner to defer income by reinvestment.

(a) To revoke, it may be necessary to file a letter ruling request or request a determination letter from the District Director.

(b) The National Office does not issue letter rulings on the replacement of involuntarily converted property, whether or not the property has been replaced, if the taxpayer has already filed a return for the tax year in which the property was converted. The District Director may issue a determination letter in such a situation.

2. Two-year reinvestment—

a. If a farmer sells livestock (other than poultry) held for draft, dairy or breeding purposes in excess of the number that would normally be sold during that time period, the sale or exchange of the excess number is treated as an involuntary conversion if the sale occurs solely on account of drought or other weather-related condition.
(1) Although it is not necessary for the livestock to have been held in the area, the sale must have been solely on account of weather-related conditions, the existence of which affected the water, grazing or other requirements of the livestock so as to necessitate their sale.

(2) Legislation has been enacted expanding the provision to include “other weather related conditions” in addition to drought. The amendment is effective for sales and exchanges after December 31, 1996.

(3) There is no required holding period for eligibility.

(4) Legislation has been introduced to extend the reinvestment provision to federal land management agency actions.

b. The number of animals that may qualify for involuntary conversion treatment is limited to the excess over the number that would have been sold or exchanged under usual business practices.

c. The livestock sold or exchanged must be replaced within the replacement period (two years after the year in which the proceeds were received) with livestock similar or related in service or use to the livestock sold or exchanged because of the weather-related condition. The new livestock must be held for the same purpose as the animals disposed of because of the weather-related condition.

d. All of the details of the disposition of the livestock are to be reported in the return for the taxable year when proceeds are received. The taxpayer is to include evidence of the existence of weather conditions which forced the disposition of the livestock, a computation of the gain involved, the number and kind of livestock sold or exchanged and the number that would have been sold or exchanged under usual business practices in the absence of weather-related conditions.

e. Apparently, I.R.C. § 1033(e) treatment can be elected on an amended return.

f. Extensions can be requested if the property cannot be replaced within the allowed time. Additional time is available for “reasonable cause.”

3. Livestock sold or destroyed on account of disease

a. If livestock are destroyed or are sold or exchanged because of disease, the disposition may be treated as an involuntary conversion.

(1) The basis of the new animals must be reduced by the unrecognized gain on the old (destroyed, sold or exchanged) animals.

(2) Losses due to the death of livestock from disease, whether from normal death loss or a disease of epidemic proportions, are treated as an involuntary conversion. Since animal disease does not qualify under the “suddenness” test as a casualty, losses because of death of livestock from disease are not considered casualty losses and are not entitled to the treatment afforded casualty losses.

(3) For loss of animals from feed contamination, the involuntary conversion provision is available.

(4) The destruction of honeybees as a result of pesticide application has been considered an involuntary conversion. However, are bees “livestock” as required by the statute? The term “livestock” is not defined in I.R.C. § 1033 but bees are not included in the definition of livestock.
(5) Dwarfism in beef cattle is not a disease so sale of a herd which had developed the dwarf gene is not eligible for involuntary conversion treatment.

(6) Amounts received are not excludible from income if the funds are not reinvested in replacement animals.

b. Livestock exposed to disease are considered sold or exchanged under this provision.

c. The replacement period ends two years after the close of the taxable year in which the involuntary conversion occurs and any part of the gain is realized.

4. Replacement of livestock with other farm property in the event of environmental or soil contamination.

a. If it is not feasible to reinvest the proceeds from compulsorily or involuntarily converted livestock in property similar or related in use to the livestock converted, other property (including real property) used for farming purposes may be treated as similar or related in service or use to the livestock converted.

b. In one case involving the sale of breeding cattle because of brucellosis (“Bang’s disease”) which made the animals unsuitable for breeding, the communicable disease was not considered to be an environmental contaminant, so the sale did not qualify for the environmental contamination provision.

5. If property held for productive use in a trade or business or for investment is compulsorily or involuntarily converted as a result of a Presidentially-declared disaster, tangible property of a type held for productive use in a trade or business is treated as property similar or related in service or use to the property so converted.

6. Federal feed assistance programs

a. IRS has ruled that, for benefits under the Emergency Livestock Feed Assistance program—

(1) Feed expenditures incurred as a result of drought for which the taxpayer had received prior authorization for partial reimbursement before the feed costs were incurred are not deductible,

(2) The remaining portion of the feed expenditures for which reimbursement is not available is deductible, and

(3) The federal reimbursements are not includible in income.

b. If prior authorization is not obtained, amounts are includible in gross income.

c. Feed assistance program benefits are not deferrable. Notice 89-55, 1989-1 C.B. 696.

d. For donated feed, the fair market value is includible in gross income but an offsetting feed deduction is allowed.

V. Constructive receipt of farm income

A. Constructive receipt

1. The cash method of accounting is complicated by the fact that taxpayers must take into account income that is constructively, as well as actually, received.
a. Income is constructively received when it is—

(1) Credited to the taxpayer’s account,

(2) Set apart for the taxpayer,

(3) Made available so the taxpayer could have drawn on it, or

(4) Could have been drawn if notice of intent to withdraw had been given.

b. Income is not constructively received if the taxpayer’s control or receipt is subject to substantial limitations or restrictions.

c. Spouses may be individually in constructive receipt as to income from jointly owned property even though reported under one spouse’s taxpayer identification number.

d. For deferrals of compensation, it appears that constructive receipt does not apply unless the funds were available to the individual, the payor was ready and willing to pay, the right to receive payments was not restricted and the failure to receive payment resulted from the individual’s own choice.

2. Important areas of possible constructive receipt of income for farmers—

a. The proceeds of livestock sold and delivered one year with proceeds received early the following year were held in 1956 to be constructively received the earlier year.

b. The year of inclusion of government price-income support payments into income—

(1) If payments are made available in a year prior to the time of regular payment with an option in the recipient to accept payment or to defer payment to the following year, the amount made available is includible in income in the earlier of the year of actual payment or the year made available to the taxpayer.

(a) Legislation has been enacted making payments under the Federal Agriculture Improvement and Reform Act of 1996 not subject to constructive receipt. That legislation followed the enactment of legislation advancing, on an elective basis, the spring, 1999 federal farm program payment, to the fall of 1998.

(b) The protection from constructive receipt was broadened in 1999, again for payments under the FAIR Act of 1996.


“The protection that was afforded producers that had an option to accelerate the receipt of any payment under a production flexibility contract payable under the Federal Agriculture Improvement and Reform Act of 1996…shall also apply to the option to receive—

“(1) the advance payment of direct payments and counter-cyclical payments under subtitle A and subtitle C; and

“(2) the single payment of compensation for eligible peanut quota holders under section 1310.”
(2) Without the Payment-in-Kind Tax Treatment Act of 1983, PIK distributions under the 1983 program would have been constructively received in 1983 even if receipt was deferred until 1984. The legislation was extended to the 1984 wheat PIK program.

(3) USDA commodity certificates are to be treated as producing taxable income when received in the same manner as cash payments. Later disposition of commodity certificates may produce further gain or loss.

VI. Deferring income to next year

A. Deferral of income from the sale of grain or livestock into a year following the year of sale—

1. Under the Installment Sales Revision Act of 1980, a farm taxpayer receiving gain from the sale of property may report the transaction on the installment method with the gain taxable as payments are received by the seller (except for recapture income required to be recognized in the year of sale) so long as the property is not required to be included in inventory under the taxpayer’s method of accounting. The installment method is not available to manufacturers and sellers of farm equipment. In a 2002 case, a farm equipment dealer could not use the installment method of reporting to sell center pivot irrigation units.

   a. Farm property is excluded from “dealer” dispositions which are not eligible for installment reporting.

   b. Installment sale treatment applies automatically to eligible transactions unless the taxpayer elects otherwise.

   c. If an installment sales contract does not provide for interest, or provides for interest at less than the minimum interest rate allowable, part of the deferred payment is considered “imputed interest,” calculated at the higher specified rate, compounded semi-annually.

   d. Under the Tax Reform Act of 1986, installment sale treatment may be denied for property of a kind regularly traded on an established market (under regulations to be issued).

   e. The Tax Reform Act of 1986 specified that amounts recognized from inventory property or property held for sale to customers in the ordinary course of business under installment sale obligations were included in alternative minimum taxable income in the year of disposition. Under the Revenue Act of 1987, for dispositions after March 1, 1987, of “property described in section 1221(1)” (basically inventory property and property held for sale to customers in the ordinary course of business), alternative minimum tax calculations were to be made without regard to the installment method.

      (1) IRS agreed that installment sales of farm products could produce AMT liability.

      (2) A pending case had been decided in accordance with the 1997 legislation.

      (3) The only litigated court decision to the time of repeal of the provision in 1997 agreed with the IRS position.

      (4) Legislation was enacted in 1997 that eliminated the AMT problem.

2. Deferred sales of crops or livestock that do not come within the provisions of the Installment Sales Revision Act of 1980 by virtue of an election out or otherwise are subject to a substantial body of regulatory and case law.
a. The consequences of electing out of installment reporting for deferred payment or deferred pricing contracts are uncertain.

(1) Under IRS regulations, a question is raised whether deferral is possible if the taxpayer elects out of installment reporting. However, that regulation may be invalid as attempting to control the consequences of transactions that have elected out.

(2) However, the Senate Finance Committee Report on the Installment Sales Revision Act of 1980 states—

"Under the bill, 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 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.

b. In 1958, IRS ruled that a binding contract for the sale of crops with payment in the following year would effectively defer income until the year of actual receipt.

(1) A number of cases have reached the same result.

(2) Arguably effective deferral for regular income tax purposes should be effective for deferral for alternative minimum tax purposes. However, IRS ruled that—

"In light of Warren Jones Co. and similar authorities, certain statements of Service position are not controlling here... ."

c. In 1979, IRS took the position in a letter ruling, that if the contract right that farm taxpayers received for their property could be assigned at fair market value, that value must be taken into account in the year of sale. In that ruling, a farmer on the cash method of accounting entered into a sales contract for grain that was delivered to the buyer in the year of the transaction but for which payment was deferred for two years. The contractual right to payment was deemed to have a fair market value with income recognized in the year of sale.

d. Deferred payment transactions to a purchaser considered to be an agent of the seller are likely to be viewed by IRS as ineligible for deferral of income tax liability.

(1) A U.S. District Court in Montana has disagreed, however, and has held that a cash basis farmer should be taxed in the year payment was received, which was the year following delivery of livestock to a market corporation that sold the livestock through an auction market.

(2) Receipt by an agent of the taxpayer is considered receipt by the taxpayer.

e. A sale of livestock under a commission arrangement has been held to result in income to the taxpayer upon sale under the theory that the commission firm is the agent of the taxpayer. That case involved sale of cattle through a public auction with the net proceeds to be paid in two installments, one in the year of sale and one in the following year. A principal-agent relationship existed, based in part on provisions of Packers and Stockyards Act prohibiting livestock markets from purchasing consigned animals for its own account.

3. Producers should include in income any advances received during the year on deferred commodity sales that are not bona fide loans.

a. Advances properly treated as bona fide loans need not be reported into income in year loan proceeds received.
b. But advances not properly characterized as bona fide loans are taxable on receipt.

c. For enterprises linked with common ownership and control, one on cash accounting (an agricultural firm) and one on accrual (processing, for example), IRS may require a shift to accrual accounting for the producing firm if the use of cash accounting results in a material distortion of income.

VII. Reporting income under conservation programs

A. Soil and water conservation expenditures

1. Until changed in 1954, expenditures related to soil and water conservation were subject to capitalization on the theory that the value of the land presumably was increased.

2. Since 1954, however, taxpayers engaged in the business of farming have been allowed to deduct soil and water conservation expenditures in the year incurred, under a one-time election, rather than to capitalize the expenditures.

a. To make the election to treat soil and water conservation expenditures as current deductions, the taxpayer must be engaged in the business of farming.

   (1) A taxpayer who "cultivates, operates, or manages a farm for gain or profit, either as owner or tenant" is engaged in the business of farming.

   (2) A landowner under a crop share or livestock share lease is engaged in the business of farming.

      (a) However, a landowner under a cash rent lease is engaged in the business of farming only if the landowner "participates to a material extent in the operation or management of the farm." Legislation has been introduced to allow a soil and water conservation expense deduction on land rented to a member of the family regardless of whether the rental is cash or share.

      (b) Participation in the 1983 or 1984 payment-in-kind (PIK) farm programs, which arguably would have produced cash-rent like income, was considered for a qualified taxpayer to be the same as though the commodities were produced. “Qualified taxpayer” status required that the taxpayer receive agricultural commodities in exchange for idling land under the PIK program.

   (3) A nursery engaged in the raising of ornamental plants is considered to be in the business of farming. However, a taxpayer engaged in forestry or the growing of timber is not in the business of farming.

   (4) According to the regulations, a person cultivating or operating a farm for recreation or pleasure rather than for profit is not in the business of farming.

b. The expenditures for which an income tax deduction is permitted are those “paid or incurred for the purpose of soil or water conservation in respect of land used in farming, or for the prevention of erosion on land used in farming, but only if such expenditures are made in furtherance of the business of farming.”

   (1) An income tax deduction may be claimed for several categories of expenditures including—

      (a) The treatment or movement of earth such as leveling, conditioning, grading, terracing, contour furrowing or restoration of soil fertility.
(b) The construction, control and protection of diversion channels, drainage ditches, irrigation ditches, earthen dams, water courses, outlets and ponds.

[1] If an earthen dam has a definite life, the costs of constructing the dam are depreciable.

[2] Costs for the construction of ponds are not deductible if the ponds have an indeterminate life.

(c) The eradication of brush.

(d) The planting of windbreaks.

(2) The election also applies to assessments by soil and water conservation or drainage districts which, if paid by the taxpayer directly, would be deductible as a soil or water conservation expense.

(a) The portion of an assessment levied by a soil and water conservation or drainage district for depreciable property (such as pumps, locks, concrete structures and similar equipment) may also be deductible within limits under the special one-time election.

(b) The deductible assessment may not exceed 10 percent of the total assessment made against all members of the district to pay the costs of acquiring depreciable property. The costs in excess of 10 percent must be added to the income tax basis of the property involved.

[1] If the difference between the deductible assessment and 10 percent of the assessment paid is $500 or less, the entire amount may be deducted under the election with the deduction claimed in the taxable year the expenditure was made.

[2] If the difference is greater than $500, the amount may only be deducted ratably over a 10-year period.

(3) Several other categories of expenditures are specifically made ineligible for the election to deduct including expenditures of a character subject to depreciation or cost recovery.

(a) This includes expenditures for the purchase, construction, installation or improvement of "structures, appliances or facilities subject to the allowance for depreciation."

(b) Expenditures for earthen dams and terraces that are not subject to an allowance for depreciation are eligible for the election to deduct costs currently.

c. To be deductible under the soil and water deduction provision, expenditures must pertain to land used in farming. In general, the land must be used for the production of crops, fruits or other agricultural products (including fish) or for the sustenance of livestock.

(1) The term "livestock" includes cattle, hogs, horses, mules, donkeys, sheep, goats, captive furbearing animals, chickens, turkeys, pigeons and other poultry. Grazing land is considered used for the "sustenance of livestock." .

(2) For land used in farming by the previous owner, the taxpayer is considered to be using the land in farming when soil and water conservation expenditures are made if the taxpayer's use of the land is substantially a continuation of its use in farming, whether for the same farming use as that of the previous owner or any of the other permissible uses.
a. Prior to amendment of the regulations in 1980, it was necessary for the taxpayer or tenant to use the land for substantially the same purpose as the previous owner.

b. In a 1978 case, where the prior cultivation of the land was so remote ("not within recorded history") that the area had to be recleared and developed into cultivable fields, the court was unable to find a "continuation" of use.

c. If only part of a tract of land has been used for farming, only soil and water conservation expenditures allocable to the part actually farmed are deductible. The allocation is made on the basis of the area actually used in farming compared to the total area of the tract unless some other method of allocation is shown to be more reasonable.

d. The deduction for soil and water conservation expense may not exceed 25 percent of the taxpayer's "gross income derived from farming" in any taxable year.

1) Any excess above the 25 percent level is deductible in succeeding taxable years, in order of time, but the carryover utilized in any year plus any soil and water conservation expenses paid or incurred that year may not exceed 25 percent of the gross income from farming in that year.

2) If the amount of soil and water conservation expense is less than the 25 percent limit, all must be claimed; the taxpayer may not deduct only part of the expense in order to carry forward the rest to a year in which the income from farming is expected to be greater.

3) The term "gross income derived from farming" is calculated under the taxpayer's regular accounting method and includes gain from the disposition of livestock held for draft, dairy, breeding or sporting purposes. However, gains from the sale of other Section 1231 assets such as farm machinery and land, are not included.

4) If the deduction for any year creates a net operating loss for the year (as computed after the 25 percent limitation), the loss is available under the general carryback and carryforward rules for net operating losses even though the taxpayer has a 25 percent deduction for soil and water conservation expenditures in the year to which the loss is carried. The part of a net operating loss carryback or carryforward that is attributable to the soil and water conservation deduction is not subject to the 25 percent limitation in any year to which it is carried as a net operating loss.

5) For a taxpayer engaged in the business of farming, who is also the beneficiary of a trust engaged in farming, the taxpayer cannot include the distributive share of trust income in determining "gross income from farming" for purposes of the 25 percent limitation on the taxpayer's deduction for soil and water conservation expense.

a) If the trust has soil and water conservation expenditures in excess of the 25 percent limitation, the excess is not available as a deduction by the beneficiary, whether or not the beneficiary is engaged in farming.

b) Upon termination of a trust, any loss carryover resulting from the allowable deduction of conservation expenses by the trust and any "excess deductions" from the last taxable year of the trust, including the allowable conservation expense deduction, are available to the beneficiary. However, any excess of the trust's soil and water conservation expense deduction over the 25 percent limitation, which is allowable as a carryover by the trust so long as it remains in existence, is not available to the beneficiary upon termination of the trust.

6) The election is made at the entity level by S corporations and, presumably, partnerships.
e. After 1986, soil and water conservation expenditures that may be deducted currently are limited to amounts incurred consistent with a conservation plan approved by the Natural Resource Conservation Service of the U.S. Department of Agriculture.

(1) If there is no Natural Resource Conservation Service plan for the area, plans of a state conservation office may fulfill the requirement.

(2) After 1986, expenditures to be deductible must be with respect to land in the United States.

(3) Expenditures for draining and filling wetlands or land preparation for center-pivot irrigation are not deductible as soil and water conservation expenses.

f. Making the election

(1) The election to deduct or capitalize soil and water conservation expenditures is made in the first year the taxpayer pays or incurs expenditures. The election does not require IRS consent and is made by entering the expenditures on the taxpayer's income tax return.

(2) The election is binding for all subsequent years unless the District Director of Internal Revenue consents to a change. A taxpayer may, however, request consent to capitalize or deduct soil and water conservation expenditures with respect to a special project of a single farm without disturbing the treatment of regularly occurring soil and water conservation expenditures.

(3) The consent applies only to expenditures incurred after the effective date of the change.

(4) A taxpayer who fails to make the election to deduct soil and water conservation expenditures for the first year such expenses were incurred may nonetheless apply for consent to deduct conservation expenses in a subsequent year. The consent does not, however, permit a deduction for items paid or incurred in a prior year.

(5) Whenever consent is required for an adoption or change of method, the request must be made not later than the due date for the return for which the adoption or change is to be effective. The request must state the amount of all conservation expenditures incurred for that year and must state that the taxpayer "will make an accounting segregation in his books and records of the expenditures to which the election relates."

(6) One court has held that the election to deduct soil and water conservation expenditures currently could not be made in a year for which a return had not been filed.

(7) In the event a taxpayer has not elected to deduct soil and water conservation expenses currently, the expenditures are added to the income tax basis of the property.

   (a) However, expenditures in excess of the limit of 25 percent of gross income do not increase the income tax basis of the property even if the property is sold before the deduction has been absorbed.

   (b) For expenditures in excess of the limit, the carryover merely remains in abeyance until the taxpayer again has gross income from farming.

(8) For tax years after 1986 and before 1996, taxpayers claiming soil and water conservation expenses had to file Form 8645 with their tax return, unless the conservation expenses were paid or incurred primarily to produce an agricultural crop. Form 8645 is no longer required. The required information can be reported on Schedule F or Form 4835.
g. Recapture on disposition

(1) If land (which the taxpayer has held for less than 10 years) is disposed of, part or all of the soil and water conservation deductions previously claimed may be recaptured with that part of the gain taxed as ordinary income.

(2) The amount of recapture is the lesser of—

(a) The "applicable percentage" of soil and water conservation expense deductions made with respect to the land, or

(b) The amount realized (in the case of sale, exchange or involuntary conversion) or the fair market value of the land over its adjusted income tax basis (in the case of any other type of disposition).

(3) Note that recapture is not based upon the number of years since soil and water conservation expenditures were paid or incurred, but upon the number of years the land was held by the taxpayer.

(4) As noted above, recapture is limited to the "applicable percentage" of deductions previously claimed.

(a) For land held five years or less, 100 percent of the deductions are subject to recapture; for land held ten years or more, none of the deductions is recaptured.

(b) For land held between five and ten years, a percentage of the deductions is recaptured—

<table>
<thead>
<tr>
<th>If the land is disposed of…</th>
<th>the applicable percentage is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Within five years after the date acquired</td>
<td>100</td>
</tr>
<tr>
<td>Within the sixth year after acquisition</td>
<td>80</td>
</tr>
<tr>
<td>Within the seventh year after acquisition</td>
<td>60</td>
</tr>
<tr>
<td>Within the eighth year after acquisition</td>
<td>40</td>
</tr>
<tr>
<td>Within the ninth year after acquisition</td>
<td>20</td>
</tr>
<tr>
<td>After the ninth year following acquisition</td>
<td>0</td>
</tr>
</tbody>
</table>

(5) If only a portion of a parcel of land is disposed of, the deductions attributable to the entire parcel are allocated to each part in proportion to the fair market value of each at the time of disposition.

(6) For land disposed of with installment reporting of gain—

(a) Income on each installment is first deemed to consist of gain attributable to recapture of soil and water conservation expense and land clearing expense deductions, until all of that gain has been reported.

(b) The remainder of the gain is ordinary income or capital gain depending upon the type of property, holding period and applicability of other recapture provisions.

(7) In general, no gain is recognized from recapture of soil and water conservation expenses on disposition of land—

(a) By gift.

(b) On gift to a charitable organization; however, the donor's charitable deduction is reduced by the amount that would have been reported as ordinary income on sale.
(c) On transfer of land at death.

(d) For tax-free exchanges, except to the extent of gain recognized.

(8) The regulations specify that any dispositions of land not provided for under I.R.C. § 1252 regulations are to be treated according to the rules under I.R.C. § 1245.

B. Other conservation programs

1. Land clearing expenditures

   a. Land clearing expenditures, like soil and water conservation expenses, were originally considered to be nondeductible capital investments and added to the income tax basis of the land.

   b. In 1962, federal legislation was enacted permitting a limited deduction, at the election of the taxpayer, for land clearing expenses. The deduction was repealed in 1986 effective for amounts paid or incurred after December 31, 1985, in taxable years ending after that date. A Committee Report notes that "routine brush clearing and other ordinary maintenance activities related to property already used in farming continue to be deductible currently to the extent the expenditures constitute ordinary and necessary business expenses of the taxpayer" under I.R.C. § 162.

   c. On sale or other disposition of land held for less than 10 years, part or all of any land clearing expenses deducted currently may be recaptured as ordinary income. The rules are the same as the recapture of soil and water conservation expense deductions as ordinary income as discussed above.


   a. EQIP is an eligible program for cost-sharing under I.R.C. § 126 so payments meeting the tests of that section can be excluded. Four of USDA’s farmer conservation programs were combined in EQIP—The Agricultural Conservation Program, Water Quality Incentives Program, Great Plains Conservation Program and Colorado River Basin Salinity Control Program.

   b. Incentive payments made to encourage on-going maintenance practices are includible in income and can be offset with allowable deductions.

3. CRP Continuous Signup Enhancements. See 7 C.F.R. Pt. 1410; see also 7 C.F.R. § 1410.50(b).

   a. Since May 1, 2000, producers have been allowed to make offers at their local USDA Service Center for a continuous sign-up for CRP contracts for several “targeted” practices—

      (1) Filter strips

      (2) Riparian buffers

      (3) Grassed waterways

      (4) Field windbreaks

      (5) Shelter belts

      (6) Living snow fences

   b. An up-front CRP signing incentive payment can be paid. These payments do not qualify for the exclusion and are reportable into income (as ordinary income).
c. A practice incentive payment (PIP) as a percentage of eligible installation costs can be paid. As with SIPs, these payments must be reported as ordinary income and are not eligible for the exclusion.


a. Under CREP, cost-sharing payments, incentive payments and annual rental payments are provided. CREP payments can include a payment for temporary or permanent easements.

b. The cost-sharing payments, incentive payments and annual rental payments are treated the same as those payments are treated under CRP.

c. For permanent easements, payments are treated first as a return of basis with remaining gain qualifying as long-term capital gain if the land has been held for more than one year.

d. A payment for a temporary easement that lasts less than 30 years is apparently treated as ordinary income. Payments for a temporary easement that lasts 30 years or more appear to be treated the same as a permanent easement.


a. WRP is a voluntary program to restore wetlands. Participating landowners can enter into conservation easements or restoration cost-sharing agreements where no easement is involved.

b. Easements are treated the same as easements under the CREP program.

c. Cost-sharing under WRP are eligible for the I.R.C. § 126 exclusion.


a. This program provides financial assistance to farmers and ranchers for the restoration of farmland or ranchland where normal farming operations have been impeded by natural disasters.

b. ECP is an eligible program under I.R.C. § 126 for permanent improvements. Expenses for permanent improvements that are not depreciable may be eligible for the soil and water conservation deduction to the extent they are not compensated by cost-sharing payments that are excluded under I.R.C. § 126.

c. Payments in the nature of maintenance (such as the removal of debris) are reported into income which can be offset by any deductions.


a. The EWP program is designed to reduce threats to life and property in the wake of natural disasters. The program provides technical and cost-sharing assistance.

b. Inasmuch as EWP is an eligible program under I.R.C. § 126, the income tax consequences are the same as for the Emergency Conservation Program.


a. The Small Watershed Program provides both technical and financial assistance for various purposes including watershed protection, flood prevention, erosion and sediment control, water supply, water quality, fish and wildlife habitat enhancement, wetlands creation and restoration and public recreation in watersheds of 250,000 acres or less.
b. SWP is an eligible program under I.R.C. § 126 with respect to federal government assistance. Some state programs are also eligible. For information about the status of state programs, contact the Natural Resource Conservation Service (NRCS) or the Farm Service Agency (FSA).

c. Expenditures for practices that protect farmland and that are consistent with an approved conservation plan can qualify as soil and water conservation expenses under I.R.C. § 175 if the expenditure—

(1) Is not currently deductible;

(2) Is not for a depreciable asset; and

(3) Was not compensated by a cost-sharing payment that was excluded under I.R.C. § 126.

d. Example: a taxpayer received a $10,000 cost-sharing payment from SWP to help pay the costs of $25,000 of soil erosion improvements. The taxpayers had average gross income of $10,000 from the affected area in the previous three years. The “value” of the § 126 improvement” is $20,000.

The taxpayer’s excludible portion of the cost-sharing payment is the present value of the greater of—

(1) 10 percent of the average annual gross receipts (10 percent of $10,000 or $1,000) or

(2) $2.50 per acre ($2.50 x 100 acres or $250).

Assuming an eight percent discount rate, the excludible portion would be—

\[ \frac{1,000}{.08} = 12,500 \]

The portion of the $10,000 cost-sharing payment that must be included in income is calculated as follows—

<table>
<thead>
<tr>
<th>Value of the § 126 improvement</th>
<th>$20,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less the excludible portion</td>
<td>12,000</td>
</tr>
<tr>
<td>Less the taxpayer’s contribution</td>
<td>7,500</td>
</tr>
<tr>
<td>($25,000 – 10,000)</td>
<td>15,000</td>
</tr>
<tr>
<td>Amount included in income</td>
<td>0</td>
</tr>
</tbody>
</table>


a. This program provides financial incentives to help develop habitat for fish and wildlife on private lands under 5 to 10-year cost-share agreements for wildlife habitat development.

b. WHIP is an eligible program under I.R.C. § 126.

c. Expense incurred under the program appear not to be eligible for the soil and water conservation deduction (I.R.C. § 175) because the expenses are not incurred to protect land used in farming.

10. Forest land Enhancement Program.
a. FIP supports good forest management practices on privately-owned, non-industrial forestlands. The program pays up to 65 percent of the cost of tree planting, timber stand improvement and related practices.

b. FIP is eligible for the I.R.C. § 126 exclusion. However, if no annual income has been produced on the land in the last three years, the limit on the exclusion is the present value of $2.50 per acre.

Example: a taxpayer received $6,500 in cost-sharing payments for the $10,000 cost of planting trees and related improvements on 100 acres of forestland. The taxpayer had no income from the land for the last three years. The excludible portion would be the present value of $2.50 per acre—

\[
\text{Present value} = \frac{100 \text{ acres} \times 2.50}{0.08} = 3,125\text{ dollars}
\]

The amount reportable income would be—

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of the § 126 improvement</td>
<td>$10,000</td>
</tr>
<tr>
<td>Less excludible portion</td>
<td>3,125</td>
</tr>
<tr>
<td></td>
<td>$6,875</td>
</tr>
<tr>
<td>Less the taxpayer’s contribution</td>
<td>3,500</td>
</tr>
<tr>
<td>Amount included in income</td>
<td>3,375</td>
</tr>
</tbody>
</table>

If, in the example, the taxpayer had sold $30,000 of timber from the land in the previous three years, the excludible portion would be the present value of the greater of—

1. 10 percent of average annual gross receipts (10 percent of $10,000 or $1,000) or
2. $2.50 per acre ($2.50 x 100 acres or $250).

Assuming an eight percent discount rate, the excludible portion would be—

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of the § 126 improvement</td>
<td>$10,000</td>
</tr>
<tr>
<td>Less excludible portion</td>
<td>12,000</td>
</tr>
<tr>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Less the taxpayer’s contribution</td>
<td>3,500</td>
</tr>
<tr>
<td>Amount included in income</td>
<td>0</td>
</tr>
</tbody>
</table>


a. It is anticipated that cost-share payments for the adoption or maintenance of management and vegetative practices will not be excludible from income. The expenses for which the cost-share payment is received will be deductible either as an ordinary farm expense (currently deductible) or as soil and water conservation expense.

b. Cost-share payments for the adoption of land-based structural practices will be eligible for the I.R.C. § 126 exclusion if the practice is a capital improvement.

c. It is expected that annual payments will receive the same income tax treatment as the annual payments under CRP.

12. Grasslands Reserve Program (GRP).

a. The program involves—
(1) 10-year, 15-year, 20-year or 30-year contracts, or

(2) 30-year or permanent easements.

b. Because the minimum easement period is 30-years, payments received for easements will first be used to reduce the basis of the affected land. Payments in excess of basis should result in capital gain treatment.

c. Cost-share payments, to restore the function and value of grasslands, will be includible in income unless the payment is a reimbursement for a practice covered under I.R.C. § 126. Expenses should be deductible as a trade or business expense or deductible as soil and water conservation expense.

C. Easements

1. Upon sale of an easement, the regulations provided general guidelines—

   “When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned amount the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction, and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of.”

2. Thus, on sale of an easement the allocation of basis involves two issues—

   a. The allocation of basis between the portion of the property subject to the easement and the rest of the property.

   b. The allocation of basis between the rights created by the easement and the rest of the rights in the property.

3. Property affected

   a. In general, only the basis allocable to the immediate area covered by the easement may be reduced.

   b. If the entire property is affected by the easement, the basis of the entire tract can be reduced.

4. Rights created by the easement

   a. The general rule is that the basis of the property must be allocated between the interest sold and the interest retained in the proportions that their respective fair market values bear to the fair market value of entire property.

   b. If it is impossible to allocate the basis of the entire property between the interest that is sold and the interest that is retained, the amount received for the easement can be used to reduce the basis in the entire property affected.

   c. However, in a ruling involving a sale of property with a retained possessory interest for 20 years, an allocation was determined to be appropriate.

   d. In the event a landowner sells or grants a perpetual easement to a portion of the land owned, with no beneficial interest retained in the portion of the land subjected to the easement, the sale or grant of the perpetual easement is treated as a sale of the land for federal income tax purposes.
VIII. New income averaging regulations

A. Income averaging for farmers

1. An individual “engaged in a farming business” may elect to average farm income by calculating the tax as though one-third of the “elected farm income” was included in income of the three prior years.

   a. “Electible farm income” is income attributable to a farming business and includes gains from the sale or other disposition of property (other than land) regularly used by the taxpayer in the farming business “for a substantial period.”

      (1) The regulations specify that "electible farm income" includes all income and gain less deductions and losses (including loss carryovers and carrybacks and including non-farm losses attributable to an individual's farming business).

      (2) Gain from land sales is ineligible for averaging.

      (3) The regulations do not exclude gains or losses from structures on the land from eligibility for income averaging. Presumably, gains and losses (and recapture income) from buildings, fences, tile lines and other improvements to land are included as gains or losses eligible for inclusion in income averaging calculations.

      (4) The regulations state that income, gain or loss from "the sale of development rights, grazing rights and other similar rights" is not treated as attributable to a farming business.

      (5) The term "elected farm income" may not exceed taxable income for the taxpayer and net capital gain attributable to a farming business may not exceed total net capital gain for the taxpayer.

         (a) A significant question is whether "elected farm income" for the election year can be negative. The income averaging statute defines elected farm income as "taxable income" which, in turn, is defined as gross income less allowed deductions. Thus, it appears that elected farm income could be negative.

         (b) However, the statute requires the "increase in tax imposed by section 1" from the three preceding years to be added to the tax computation. Therefore, if a farm taxpayer had negative elected farm income, a strong argument could be made that the negative amount cannot be factored in when computing the electing year's tax liability. Unfortunately, the regulations do not address the issue.

      (6) The meaning of “substantial period” is unclear with no guidance provided in the committee reports.

   b. The tax is calculated by figuring the tax on the taxable income for the year reduced by “elected farm income” plus the increase in tax which would result if taxable income for each of the three prior taxable years were increased by an amount equal to one-third of the “elected farm income.”

      (1) The regulations state that an individual with both ordinary income and net capital gain farm income (presumably including Section 1231 gains) may elect, up to electible farm income, any combination of ordinary income and net capital gains.

      (2) In making that determination, net capital losses first offset net capital gains, both farm and non-farm, before reducing ordinary income.
(3) The rule that capital losses can only offset up to $3,000 of ordinary income per year still applies for purposes of elected farm income calculations, also.

(4) Thus, a taxpayer can elect to carryback only ordinary income, only capital gain income or any combination after making these adjustments.

(5) Once the taxpayer decides how much and what type of elected farm income to carryback to the three prior years, one-third of each type of elected farm income is then allocated to each of the base years.

(6) The *Farmers Tax Guide*, Pub. 225 (2000) and the Instructions to Schedule J stated that negative taxable income for the carryback years can be combined with elected farm income. Amended returns can be filed for 1998 and 1999 to take negative taxable income figures into account. The final regulations issued on January 7, 2002, agree with that position.

c. Any adjustment for any taxable year is taken into account for income averaging purposes in subsequent taxable years.

d. Eligible taxpayers—

(1) The statute makes it clear that only individuals are eligible for income averaging.

(2) Estates and trusts are specifically made ineligible.

(3) C corporations are not considered to be individuals.

(4) Entities taxed as partnerships pass through income items to the partners who, if they are individuals, are able to elect income averaging.

(5) For S corporations, the character of income from corporate distributions continues in the hands of the shareholders who are eligible to average.

(6) The proposed regulations took the position that "farm income" did not include "wages." However, the final regulations state that wages attributable to a farming business are eligible for income averaging for an S corporation employee.

2. Meaning of “farm business” (type of operation).

a. An individual electing income averaging under the new rule must be “engaged in a farming business.”

(1) Presumably, that means an individual must be engaged in a farming business in the year for which the election is made but need not have been necessarily engaged in a farming business in the three prior carryback years.

(2) The definition of the term “farming business” is found in I.R.C. § 263A(e)(4).

(a) “Farming business” under the regulations, “means a trade or business involving the cultivation of the land or the raising and harvesting of any agricultural or horticultural commodity. Examples include the trade or business of operating a nursery or sod farm; the raising or harvesting of crops; the raising or harvesting of trees bearing fruit, nuts or other crops; the raising of ornamental trees; and the raising, shearing, feeding, caring for, training, and management of animals.” An evergreen tree more than six years old at the time it is severed from the roots is not treated as an ornamental tree.
(b) The term “farming business” does not include the processing of commodities or products “beyond those activities which are normally incident to the growing, raising or harvesting of such products.”

   a. Operators of farming businesses, bearing the risks of production and the risks of price change and providing substantial involvement in management, are clearly eligible.
   b. Landowners under material participation crop share and livestock share leases have generally been considered to be engaged in a business, file Schedule F and are generally treated the same as farm operators for federal tax purposes.
   c. The major question is whether landlords under non-material participation share leases who report their income and expenses on Form 4835 are engaged in a “farming business.”
      (1) The final regulations specify that rental income based on a tenant’s production (a share lease) is treated as income from a farming business if, after December 31, 2002, the landlord’s share of production is set in a written rental agreement entered into before the tenant begins significant activities.
      (2) Whether the landlord is materially participating in the operation is immaterial.
   d. It is certain that landlords under cash rent leases are not considered to be engaged in a “farming business.”
   e. It would seem that individuals who have ceased farming operations with the only activity in the year in question being the sale of inventory and the sale of machinery are not engaged in a “farming business” in that year.
      (1) For gains or losses from such property after cessation of the farming business, the gain or loss is treated as attributable to a farming business if the property is sold within a reasonable time after cessation of the farming business.
      (2) A sale or other disposition within one year of cessation of the farming business is presumed to be within a reasonable time.
      (3) Beyond one year, it becomes a facts and circumstances question.

4. Income averaging is available only for the “tax imposed by section 1.”
   a. The proposed regulations make it clear, as does the statute, that income averaging affects only "Section 1 tax" (federal income tax) and has no application to employment taxes (FICA, FUTA, SECA or income tax withholding). Moreover, the proposed regulations state that income averaging does not apply for purposes of figuring alternative minimum tax. The inapplicability of income averaging to AMT confirms that benefits of income averaging are severely limited.
      (1) The Section 1 tax is to be determined by allocating elected farm income to the base years only after all other adjustments and determinations have been made. Thus, any net operating loss carryovers or net capital loss carryovers are applied to an election year before allocating elected farm income to the base years. Similarly, the determination of whether there is a net Section 1231 gain or loss in the election year and the character of the Section 1231 items are made before allocating elected farm income to the base years.
(2) The allocation of elected farm income to the base years does not affect any determination (other than for the calculation of the Section 1 tax attributable to the elected farm income) with respect to the election year or the base years. As the regulations note, in applying the limitation on itemized deductions to the election year, adjusted gross income for that year includes any elected farm income allocated to the base years. Likewise, the same limitation for the base years is not recomputed to take into account any allocation of elected farm income to the base years.

(3) The calculation of the Section 1 tax on elected farm income allocated to a base year is made without any additional adjustments or determinations with respect to that year. Thus, if a base year had a partially used capital loss, the rest of the loss could not be used to reduce the elected farm income allocated to that year. The same is true of credits for the base year.

b. The Conference Committee report states that the election is irrevocable except as provided in regulations.

(1) The statute is unclear as to whether the income averaging election could be made on an amended return.

(2) The regulations state that an individual may make a late income averaging election or revoke or change a previous election if the period of limitations has not expired.

c. The provision does not require the recalculation of the tax liability of any other taxpayer such as a minor child required to use the parents' rates in figuring their own tax liability.

5. Status of the taxpayer.

a. Under the regulations, an individual is not prohibited from making a farm income averaging election solely because the individual's filing status is not the same in the election year and the base years. Thus, an individual who files as a married taxpayer filing jointly in the election year but filed as a single taxpayer in all of the base years may still elect to average income.

b. The regulations do not, however, address problems with community property states or situations more generally when the spouses are both involved in the business. Presumably, farm income must be identified and associated with the appropriate taxpayer.

c. The regulations do not provide decision rules on how to allocate the remainder of the tax brackets as between former spouses who had filed jointly.

6. The provision was originally effective for taxable years beginning after December 31, 1997, and before January 1, 2001. Therefore, the provision was effective for calendar year taxpayers for 1998, 1999, and 2000 and was scheduled to sunset at the end of the three-year period. Legislation has been adopted making income averaging for farmers permanent.

IX. Prepayment of expenses

A. Prepaid feed and other expenses

1. Until 1949, IRS allowed an income deduction for advance purchases of feed and other supplies.

2. Commencing in 1949, IRS has litigated several cases of late year end purchases with only modest success.

3. The IRS position on deductibility of prepaid expense has been stated in a 1979 IRS ruling—
a. The prepayment transaction must be a purchase and not a deposit.

b. The prepayment must be for a business purpose and not merely for tax avoidance. A business purpose may include—
   
   (1) Assuring supply,

   (2) Securing preferential treatment to avoid a shortage,

   (3) Fixing the price to avoid a price increase, or

   (4) Continuing a consistent practice in the business community.

c. The deduction must not result in material distortion of income. The Eighth Circuit Court of Appeals has held that a district court’s reliance on the 1979 ruling was reasonable. In that case, a cash basis turkey operation did not have valid business purpose for prepurchase.

4. A "farming syndicate" is prevented from deducting feed, seed, fertilizer and other farm supplies until used or consumed.

   a. A farming syndicate is a partnership or other enterprise (other than a regularly-taxed corporation) engaged in farming if ownership interests have been offered for sale in an offering required to be registered with state or federal securities agencies or a partnership or other enterprise (other than a regularly taxed corporation) engaged in farming if more than 35 percent of the losses are allocable to limited partners or limited entrepreneurs.

   (1) Former proposed regulations took the position that a farming syndicate could include a general or limited partnership, a sole proprietorship involving an agency relationship created by a management contract, a trust, a common trust fund and an S corporation.

   (2) The term "limited entrepreneur," which is a key term in the farming syndicate statute, was defined in the regulations as—

   
   "...a person who has an interest in an enterprise other than as a limited partner and who does not actively participate in the management of such enterprise. The determination of whether a person actively participates in management or operation of a farming enterprise depends on the facts and circumstances of each case. Factors which tend to indicate active participation include participating in the decisions involving the operation or management of the farm, actually working on the farm, living on the farm, or hiring and discharging employees (as compared to only the farm manager). Factors which tend to indicate a lack of active participation include lack of control of the management and operation of the farm, having authority only to discharge the farm manager, having a farm manager who is an independent contractor rather than an employee, and having limited liability for farm losses...[lack of fee ownership of the farm land shall not be a factor indicating a lack of active participation."

   The proposed regulations did not address, directly, the question of imputation of an agent's management activities to the principal which is generally the case except where imputation is specifically barred by statute. Reference in the former proposed regulations to farm managers as employees and farm managers as independent contractors (which is often not the case) omitted the status of farm manager as agent which is a typical owner-farm manager relationship.

   b. The rules limiting deductibility for the cost of inputs do not apply to—

   (1) Amounts on hand at the end of the year because of fire, storm, flood or other casualty or because of disease or drought, or

   (2) Amounts to be charged to capital account.
c. The following are not considered to be interests of a limited partner or limited entrepreneur—

(1) Individuals who have participated for not less than five years in the management of the business of farming,

(2) Individuals residing on the farm,

(3) Individuals actively participating in the farming business or in the further processing of livestock raised in the business,

(4) Individuals whose principal business activity involves active participation in the business of farming (even though it is not the business in question), and

(5) Any interest held by a member of the family (or a spouse) of a grandparent of an individual described above who is actively participating in the business. The term "family" has the same meaning as in I.R.C. § 267(c)(4).

5. Limitations added in 1984—

a. For farmers on the accrual method of accounting who prepay inputs such as feed, seed or fertilizer, deductibility is not assured until "economic performance" occurs.

(1) For property provided to the taxpayer, economic performance occurs when the person provides the property. For services, economic performance occurs when the services are provided.

(2) Under an exception to the "economic performance" test, a deduction is permitted if economic performance occurs within the shorter of a "reasonable period" after the close of the taxable year or eight and one-half months after the close of the taxable year, the item is recurring in nature and the item is either "not a material item" or there would be a "more proper match" of income and expense if deductibility were delayed. I.R.C. § 461(h)(3)(A).

b. A tax shelter on the cash method of accounting may not deduct prepaid expenses until both "economic performance" occurs and the expense is paid unless economic performance occurs within 90 days after the end of the taxable year of payment.

(1) Unless the conditions are met, the income tax deduction is limited to the cash investment made by the taxpayer.

(2) For partnership tax shelters, the taxpayer's income tax basis in the partnership is determined without regard to any liabilities of the partnership. Similar rules apply to other types of tax shelters.

(3) For purposes of prepayment of expenses, a tax shelter is defined the same as a farming syndicate.

(4) The prepaid expense provisions apply to individual taxpayers engaged in farming activities with the principal purpose of tax avoidance. The Conference Committee report states—

"The conferees intend that marketed arrangements in which individuals carry on farming activities utilizing the assistance of a common managerial or administrative service may be presumed under certain circumstances to have the principal purpose of tax avoidance. If under such circumstances, taxpayers prepay a substantial portion of their farming expenses with borrowed funds, they should generally be presumed to have a principal purpose of tax avoidance."
The Conference Committee report also states that "section 464 will be applied before the prepaid expense provision and that accrual method tax shelters will be subject to the timing rules of section 464."

6. Rules added in 1986 effective for amounts paid or incurred after March 1, 1986, in taxable years beginning after that date—

a. Amounts paid by a taxpayer on the cash method of accounting for excess prepaid farm supplies are subject to the farming syndicate rules and in general are deductible no earlier than when used or consumed to the extent prepaid expenses exceed 50 percent of total deductible farming expenses excluding prepaid expenses.

(1) For this purpose, "deductible farming expense" is defined as including all amounts "allowable" as deductions for income tax purposes including depreciation or amortization which is properly allocable to the trade or business of farming.

(2) A Committee Report states that the term includes the “operating expenses of the farm such as ordinary and necessary farming expenses deductible under section 162, interest and taxes paid, depreciation allowances on farm equipment and other expenses (generally those reported on Schedule F of the taxpayer’s Federal income tax return).”

(3) Apparently, payments for feed, seed, fertilizer, and other farm supplies are deductible farm expenses only to the extent they are not prepayments.

**Example**

A farmer had $70,000 of non-prepaid expenses for 1996 comprised of feed, seed, and fertilizer paid for and used during the year; interest and taxes paid during the year and depreciation claimed for the year. The farmer also had $40,000 of prepaid expense during 1996 for feed, seed, and fertilizer to be used in 1997. The farmer could deduct on the 1996 income tax return the $70,000 of expenses actually used in 1996 plus $35,000 of the prepaid expenses (50 percent of the $70,000). The remaining $5,000 could be deducted in the year the items are used in the business, presumably in 1997.

b. Two exceptions are provided for the 50 percent test—

(1) A farmer is permitted to continue to deduct prepaid expenses under prior rules even though the prepaid expenses are greater than 50 percent of deductible farming expenses for that year if the failure to meet the 50 percent test was because of a change in business operations directly attributable to extraordinary circumstances.

(a) A Committee Report states that the statutory language covers circumstances including government crop diversion programs and circumstances identified in I.R.C. § 464(d) including fire, storm, flood, or other casualty or on account of disease or drought.

(b) Legislation has been introduced to make enactment of the Agricultural Market Transition Act an extra ordinary circumstance.

(2) If a "qualified farm-related taxpayer" satisfies the 50 percent test on the basis of the three preceding taxable years, the test is met.

(a) The expenses of the past three years are aggregated to determine if the 50 percent test was met over that time period. It is not clear how the expenses over the past three years are to be aggregated.
[1] Are carryover expenses to the three year period ignored?

[2] Are carryover expenses from the three year period ignored?

[3] Is the 50 percent test applied each year with the excess carried over to the following year?

[4] If the taxpayer fails the three year test, what deduction is allowed?

(b) For this purpose, "qualified farm-related taxpayer" includes—

[1] Any taxpayer whose principal residence is on a farm.


[3] Any member of the family of persons described in (1) and (2).

(c) The second exception applies "only to an eligible farmer's farming activities attributable to the farm on which the residence is located, or to persons included in the principal occupation of farming activities."

X. When are payments considered made

A. When deductions can be claimed —

1. For taxpayers on the cash method of accounting, amounts for feed and other supplies may be deducted when "paid."

2. Payment with promissory note, even secured by collateral, does not produce a deduction. The same applies if secured by a letter of credit.

3. A deduction may be claimed if funds are borrowed from a third party and used to pay for feed or other supplies.

4. Improvements to property which are financed by a promissory note or other obligation do not add to basis until paid which affects when depreciation can be claimed.

5. Costs incurred in connection with the acquisition of capital assets must be capitalized.

XI. Like-kind exchanges and related party rules

A. Exchanges involving related parties

1. If, within two years of a like-kind exchange of property with a related person, the related person disposes of the property, or the taxpayer disposes of the property, the gain is recognized.
a. Like-kind exchange treatment is denied for exchanges structured to avoid the related party rules.

b. A primary objective in enactment of the related party rules was to deny non-recognition treatment for transactions in which related parties make like-kind exchanges of high basis property for low basis property in anticipation of sale of the low basis property. The related parties have, in effect, “cashed out” of the investment and the original exchange is not accorded non-recognition treatment.

2. That provision does not apply to—

a. Dispositions involving the death of the taxpayer or the related person.

b. In a later compulsory or involuntary conversion.

c. Where IRS is satisfied that avoidance of federal income tax is not a principal purpose of the transaction. This exception includes—

(1) Transactions involving an exchange of undivided interests in different properties that result in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of the properties;

(2) Dispositions of property in non-recognition transactions; and

(3) Transactions that do not involve the shifting of basis between properties. IRS has ruled that exchange of an undivided interest for a whole interest is not a “disposition” of property subject to the waiting period for related-party transactions.

3. For this purpose, “related person” is as defined in I.R.C. §§ 267(b), 707(b)(1).

4. Routing the exchange through an unrelated party to avoid the related party rules does not avoid the denial of like-kind exchange treatment.

XII. Repairs v. capital expenditures

A. Amounts incurred for maintenance and repairs are deductible as ordinary and necessary business expenses.

1. Expenditures that restore a building to its previous condition without adding to the value of the building or prolonging its life are properly deductible.

2. Engine overhaul has been held to be an item which can be expensed. *Ingram Industries, Inc. & Subs., T.C. Memo. 2000-323* (towboat diesel engines; out of operation for 10-12 days).

XIII. Futures transactions

A. Gains and losses from commodity futures

1. In the same manner as other merchants and manufacturers, farm taxpayers buy and sell commodity futures to hedge against fluctuating prices. Likewise, farm and ranch taxpayers buy and sell commodity futures as speculators. The principal matter of concern from an income tax perspective in the farm and ranch area is the line between hedging and speculation.
2. Hedging transactions are defined in terms of reducing the risk of price (or interest rate) fluctuations in the ordinary course of the taxpayer’s business. The 1999 legislative change to the definition of a hedging transaction (substituting “managing” for “reducing”) is effective December 17, 1999. Final regulations have been issued for the 1999 amendments. The regulations define a hedge as —

“… a transaction…that a taxpayer enters into in the normal course of the taxpayer’s trade or business primarily —

“(1) To manage risk of price changes or currency fluctuations with respect to ordinary property…that is held…by the taxpayer;

“(2) To manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer,” or

“(3) To manage such other risks as the Secretary may prescribe in regulations….”

a. Hedging gains and losses generate ordinary income and loss and are not subject to the loss deferral rules and the “mark-to-market” provisions that are applicable to speculative transactions.

b. Commodity futures gains and losses that do not qualify as hedges and that do not involve contracts primarily for sale to customers in the ordinary course of a trade or business are treated as capital gains and losses.

c. If transactions are not entered into primarily for profit, losses may not be deductible.

d. Straddle losses—

(1) Taxpayers are entitled to offset straddle losses only to the extent of straddle gains.

(2) IRS has indicated the circumstances under which the tax benefits from partnership tax straddles are disallowed.

e. The exemption for hedging transactions does not apply to transactions entered into by syndicates. A syndicate is any partnership or other entity (other than a C corporation) if more than 35 percent of the entity’s losses are allocable to limited partners or limited entrepreneurs.

f. Contracts subject to the mark-to-market rules are subject to recognition of gain on transfer.

g. The character of gain or loss on the sale or exchange of a securities futures contract is the same as the character of gain or loss from the sale or exchange of property to which the contract relates.

3. Gains from speculative transactions are treated as capital gains; losses are reported as capital losses.

a. Positions in regulated futures contracts are subject to the “mark-to-market” rules and are treated as if sold on the last day of the year.

(1) Gains or losses arising from those calculations are treated as if they were 60 percent long-term and 40 percent short-term without regard to the actual holding period.

(2) Hedging transactions are exempt from these rules.

(3) It would appear that hedge-to-arrive contracts are not “regulated futures contracts.”

b. Long-term capital losses can be used to offset long-term capital gains and, for individuals, up to $3,000 of ordinary income each year.

(1) Excess capital losses can be carried forward indefinitely for individuals, I.R.C. § 1212(h), and for up to five years for corporate taxpayers.
(2) Losses from regulated futures contracts can be carried back by individuals to the three prior years.

(a) The maximum loss that may be carried back to any year is the regulated futures gain in that year (without regard to regulated futures losses). This is the lesser of the net capital gain for the year, taking into account only gains and losses from regulated futures contracts or the net capital gain income from the tax year.

4. Courts emphasize two tests in evaluating commodity futures transactions as hedges or as speculative ventures —

a. The insurance test:

(1) If the taxpayer uses futures trading to offset price changes in actual commodities (the “actuals”), the futures transactions are hedges.

(2) Even if the taxpayer was not using futures trading to offset price movements in actuals, the U.S. Supreme Court has held that futures trading was hedging and not speculation if the commodity transactions were an integral part of the taxpayer’s business as where futures trading was used as price insurance against subsequent price increases with respect to needed raw materials.

(a) In a 1955 U.S. Supreme Court case, the taxpayer purchased corn futures during harvest when prices were lower as a “pre-hedge” effort to guard against price increases. The court held that the transactions were not speculative dealings but were an integral part of its business and were designed to assure a ready supply of corn for manufacturing purposes while protecting itself against price increases. The court denied long-term capital gain treatment for profits from futures transactions (which is the proper treatment for speculative gains) and held that the gains were ordinary income.

(b) Recently, the courts have been asked to apply that concept to post-harvest sales of crops and purchases of like amounts of commodities in the futures market under the theory that the post-harvest position in the futures market was an integral part of the farming operation. IRS restated that position in the preamble to the regulations on hedging issued in final form in 1994. 59 Fed. Reg. 36361-36362 (1994).

(c) The U.S. Supreme Court, in a 1988 case, limited the 1955 decision to its facts in allowing ordinary income from sales of commodity futures —

“Corn Products is properly interpreted as standing for the narrow proposition that hedging transactions that are an integral part of a business’ inventory-purchase system fall within the inventory exclusion of § 1221.”

(3) After 1988, IRS took the position that futures market transactions involving the purchase of puts (short hedges) were not hedges and were to be treated as capital assets.

(4) However, the Tax Court has held that hedging of debentures and mortgages with short sales of U.S. Treasury securities produced ordinary gains and losses.

(a) The court agreed with the taxpayer that it was not necessary to offset the entire risk for the transaction to be a hedge.

(b) The court noted that for a hedging position to produce ordinary gain and loss treatment, the transaction must be integrally related to the purchasing and holding of the assets hedged.
The IRS has abandoned its position in regulations initially issued in late 1993 and made final in 1994.

(a) To receive ordinary loss treatment, taxpayers must identify hedges when entered into along with the item or items hedged.

[1] Hedging transactions entered into on or after January 1, 1994, must be identified as such before the close of the day on which the taxpayer enters into the hedge. The hedged items or aggregate risk must be identified within 35 days after entering into the hedging transactions. The identification must be made and retained on the taxpayer’s books and records and must specify the hedging transaction and what is being hedged.

[2] For hedges entered into before January 1, 1994, that remained in existence on March 31, 1994, the identification had to be made before the close of business on March 31, 1994.

(b) Consequences of failure to identify properly —

[1] If a taxpayer identifies a transaction as a hedging transaction and it is not a hedge, gains are ordinary but losses may be capital.

[2] If a transaction satisfies the definition of a hedge but it is not identified as a hedge, gains are ordinary and losses are capital. Exceptions are provided for inadvertence.

[3] Thus, the regulations have been made the exclusive way to receive treatment as a hedge. That result has been criticized.

(c) A taxpayer may hedge any part or all of its risk for any part of the period during which it has risk. The frequent entering into and termination of hedging positions are not relevant to whether transactions are hedges.

(d) Non inventory supplies may be hedged if only a negligible amount is sold.

(e) For a hedging program undertaken to reduce the overall risk of the taxpayer’s operation, the taxpayer generally does not have to demonstrate that each hedge entered into pursuant to the program reduced overall risk.

(f) A taxpayer who attempts to hedge cannot attribute an S corporation’s business to the taxpayer for purposes of satisfying the definition of a hedging transaction.

(g) In the preamble to the final regulations issued in 1994, IRS seemed to sanction the hedging of deficiency payments —

“The IRS and Treasury understand that there are situations in which a taxpayer engages in a store-on-the-board transaction as a hedge of an expected payment under an agricultural price support program. In this situation, a long futures or forward contract may qualify as a hedging transaction with respect to the expected payment.”

(h) Interest rate swaps by banks following the purchase of fixed rate, tax-exempt bonds has qualified as a hedge even though the swaps reduced the risk with respect to assets that gave risk to tax-exempt income.

(6) In a 1993 case, a commodity trader’s losses resulting from cancellation of forward contracts and replacement with new contracts having different delivery dates were ordinary losses.
b. The “direct relation” test:

(1) Under the “direct relation” test, there must be a direct relation between the taxpayer’s business and the commodity market transaction if the transaction is to be considered a hedge.

(2) For the direct relation test to be met, the amount of futures trading in the particular commodity involved and the timing of purchases and sales must be related to the position of the taxpayer in the actuals. Thus, where the amount of futures trading exceeds substantially that needed to provide price protection for actual commodities or the pattern of purchases and sales in futures is not consistent with securing price protection for the actuals, the transactions are likely to be treated as speculative rather than hedges with the result that gains and losses are capital gains and losses.

5. Accounting for hedging transactions

a. The method of accounting used by a taxpayer for a hedging transaction must clearly reflect income.

(1) To clearly reflect income, the method used must reasonably match the timing of income, deductions, gains or losses from the hedging transaction with the timing of income, deduction, gain or loss from the items being hedged.

(2) Taking gains and losses into account in the period in which they are realized may clearly reflect income for hedging transactions.

(3) For hedges of inventory, gain or loss on the hedge may be taken into account in the same period that it would be taken into account if the gain or loss were treated as an element of the cost of inventory.

(4) A taxpayer is generally permitted to adopt a method of accounting for a particular type of hedging transaction that clearly reflects the taxpayer’s income from that type of transaction. Once a method is adopted, it must be applied consistently.

(5) The records must contain a description of the accounting method used.

(6) A taxpayer on the cash method of accounting with less than $5,000,000 of gross receipts for all taxable years ending on or after September 30, 1993, is not required to use the above rules. However, such a taxpayer may nonetheless use a method of accounting consistent with these rules.

b. If a taxpayer hedges an item and disposes of or terminates its interest in the item but does not dispose of or terminate the hedge, the taxpayer must appropriately match the built-in gain or loss on the hedging transaction to the gain or loss on the disposed item. Thus, hedges may be “marked to market” on the date the actuals are disposed.

c. For “recycled” hedges, with a hedge later used to serve as a hedge of a different item, the taxpayer must match the built-in gain or loss at the time of the recycling to the gain or loss on the original hedged item. Gains or losses attributable to the period after recycling must be matched to the new hedged item.

XIV. Income in respect of decedent

A. Property defined as “income in respect of decedent” does not receive a new or adjusted income tax basis at death through 2009 and will not thereafter.
1. Income items uncollected at death are later subjected to income taxation to someone other than the decedent, e.g., the estate, heir or beneficiary. If income in respect of decedent items are distributed by the estate, the items remain subject to income tax and are not subject to the rules of I.R.C. §§ 661, 662 allowing a deduction for amounts paid or credited to a beneficiary.

2. For farm property held until death, the major item of concern as income in respect of decedent has been share rents.
   a. Share rents held by a non-materially participating decedent at death or share rents which the decedent had a right to receive at the time of death for economic activities occurring before death are income in respect of decedent taxable on subsequent sale by the estate or other successor.
      (1) If a non-materially participating landlord dies during a rent period, with crops and livestock sold after death, the portion of the proceeds allocable to the period before death is income in respect of decedent. That portion is also includible in the gross estate for federal estate tax purposes as accrued rent. The remaining amount represents ordinary income earned by the estate after the landlord's death. The proceeds of sale are apportioned according to the number of days in the rental period before and after death.
      (2) For rents received in kind and held by the landlord at the time of death which are later sold, the proceeds of sale are similarly allocated between income in respect of decedent and ordinary income.
      (3) What if crop share rents are fed to livestock before death? Presumably, the animals (if owned on shares) would be treated as income in respect of decedent. If crop share rents are fed by the estate to livestock, the crops would have a zero basis and the income would be recognized on sale of the livestock (with no deduction for the zero basis crops as feed).
   b. A landlord's share of rental items is not treated as income in respect of decedent if the decedent was a "materially participating" landlord. If this issue is raised, as a matter of pre-death or post-death estate planning, it should be noted that material participation by a landlord creates possible liability for self-employment taxes even after the landlord is retired and receiving benefits. Therefore, raising the issue might subject the estate to claims for self-employment tax for prior years.
   c. Of course, to a cash basis farmer, unsold livestock and grain inventories are not income in respect of decedent. For an accrual basis farmer, these items would be included in the closing inventory on the decedent's return and would take on a date of death basis.
   d. If material participation is achieved by agent, can the landowner—(1) avoid self-employment tax, (2) avoid loss of social security benefits (before reaching age 65) and (3) assure a new income tax basis for growing crops and livestock and stored crops at the time of death?

3. Interest on Series E bonds is also income in respect of decedent.
   a. The executor may elect to report the interest increment on the Series E bonds on the final return of the decedent even though the decedent held the bonds uncashed at death.
   b. If Series E bonds are redeemed by the estate, the interest amount is includible in the gross income of the estate as income in respect of decedent.
   c. The bonds could be held uncashed with the ultimate beneficiary reporting the interest income.

4. Interest on certificates of deposit attributable to the period ending with the date of decedent's death but not received as of the date of death is income in respect of decedent.
5. Installment contracts or notes may also create income in respect of decedent. Installment notes received by married taxpayers on sale of community property were income in respect of decedent and not entitled to new basis at death.

6. Sales contracts for farm products entered into before death may not produce income in respect of decedent if a significant economic contribution is made by the estate after death.

7. Gain from sale of property may produce income in respect of decedent where the sale is completed by the personal representative.
   a. In order for a sale of property to have ripened to the point where a decedent has the right to the proceeds on the date of death, two conditions must be met —
      (1) There must be a legally binding contract,
      (2) The decedent must have performed the substantive (as opposed to ministerial) acts required as preconditions of sale.
   b. In one case, where the buyer would not accept title unless clouds on title were cured or a purchase price adjustment was made, the item was not income in respect of decedent.

8. Merely granting an option to purchase real estate does not convert the property into income in respect of decedent.

9. Distributions from retirement plans constitute income in respect of decedent.
   a. Distributions are generally taxable when paid out with several exceptions
      (1) Proceeds from life insurance policies held in the qualified plan in excess of cash value and payable to named beneficiaries.
      (2) Voluntary contributions by the employee.
      (3) P.S. 58 costs, on which the employee has paid tax.
      (4) The $5,000 death benefit (repealed in 1996).
      (5) Non-deductible IRA contributions.
   b. Distributions from an IRA to an estate to pay the estate taxes attributable to inclusion of the IRA in the estate are viewed by IRS as income in respect of decedent.
   c. Distributions from a friend's retirement account are income in respect of decedent.
   d. The portion of a lump-sum distribution to a non-spouse beneficiary of a decedent's IRA equal to the balance of the IRA less prior non-deductible contributions is income in respect of decedent.
   e. An interest in a qualified retirement plan which would produce income in respect of decedent upon distributions apparently can be disclaimed without triggering income tax consequences for the designated beneficiary who makes a qualified disclaimer.
   f. A distribution of retirement plan benefits to a charitable remainder trust upon the death of the plan participant is not taxable to the recipient or spouse and is non-taxable income in respect of decedent of the charitable beneficiary. Proceeds of decedent's qualified retirement plan were IRD,
taxable to charitable remainder trust in year proceeds received by trust; however, only UBIT subject to tax if trust was qualified charitable trust.

g. Fund transfers to the administrator of an estate are includible in the estate’s gross income.

h. IRA proceeds and retirement plan benefits that would have been gross income to the decedent are income in respect of decedent when distributed to a private foundation.

10. If an agreement between an author and publisher is a license, a new basis is acquired in the copyright at death.

11. Disposition of income in respect of decedent items —

a. Transfer of an IRD item is ordinarily a recognition event for non-charitable transferees.

   (1) This includes transfer by sale, gift, exchange or other disposition or the satisfaction of an installment obligation at other than face value.

   (2) In the event of a gift, the gain in the IRD item is based on the fair market value of the IRD item at the time of the gift.

   (3) There is ordinarily no income in respect of decedent triggered where a decedent’s IRA is transferred to the surviving spouse’s IRA.

b. In general, disposition of an item of IRD to a charitable organization also triggers gain.

   (1) IRS has ruled that an in-kind distribution of Series E and Series HH U.S. savings bonds from a decedent’s estate to a charitable beneficiary does not trigger gain as to the unreported interest. In that ruling, the will directed that the residuary estate be distributed in fractional shares to four charitable beneficiaries, but, under fiduciary powers, the estate distributed cash to three and bonds to fourth beneficiary; because decedent’s will and local law allowed non-pro rata property distributions, distribution of bonds was not deemed a pro rata distribution followed by exchange by beneficiaries.

   (2) A bequest of stock options to a charity has produced income in respect of decedent to the charity, not to the estate.

c. If property is paid or distributed in kind, no gain or loss is realized by the estate or other beneficiary by reason of the distribution unless the distribution is in satisfaction of a right to a specific dollar amount or specific property other than that distributed.

d. If an installment obligation passes into an estate and in turn is transferred to a beneficiary of the estate, the event is not immediately taxable unless the obligor is a beneficiary.

e. Earnings from a variable annuity contract are income in respect of decedent when distributed to beneficiaries to the extent it exceeds the investment in the contract.

B. Income tax deduction

1. A taxpayer reporting income in respect of decedent is entitled to an income tax deduction for the federal estate tax on rights to receive income in respect of decedent that are included in the decedent’s gross estate.

   a. The deduction is apparently available if the decedent held only a limited interest (such as a life estate) and at death the property passed to holders of the remainder interest.
b. The deduction is to be claimed as a deduction from gross income.

c. The deduction can be claimed even though the federal estate tax has not been paid.

d. The income tax deduction is proportionate to the income in respect of decedent reported.

e. The estate is required to allocate IRD to the marital deduction when computing the I.R.C. § 691 deduction in some circumstances.

2. The deduction is based on the highest marginal federal estate tax rate.

   a. The net value of income in respect of decedent items is figured by subtracting the deductions and credits in respect of the decedent for expenses, interest, taxes and depletion and the foreign tax credit.

   b. In computing the hypothetical estate tax for income in respect of decedent that is included in the decedent's gross estate, an adjustment to the amount of the marital deduction is required where the marital bequest provides that the surviving spouse is to receive one-half of the net estate.

   c. If long-term capital gains are involved, a question exists whether the deduction for death taxes paid attributable to income in respect of decedent items can be subtracted from adjusted gross income (which includes only 40 percent of long-term capital gains through 1986) or whether the deduction should be claimed before reduction of long-term capital gains by 60 percent. The Tax Court and the 10th Court of Appeal held in favor of the taxpayer, allowing the deduction after long-term capital gains were reduced by 50 percent (the deduction at that time). IRS agrees, for deaths on or before November 6, 1978.

   (1) For deaths after November 6, 1978, the deduction for death taxes paid attributable to income in respect of decedent is to be applied first. Thus, for purposes of computing the long-term capital gains deduction, the amount of the gain is to be reduced (but not below zero) by the amount of any applicable deduction for estate taxes attributable to income in respect of decedent. Deduction for estate tax attributable to amounts received as long-term capital gain on installment obligation is claimed as reduction in amount of long-term capital gain reported by decedent's estate.
Legal Issues, Part 2*  
(Estate and Business Planning)  

—by Neil E. Harl**

I. Succession planning

A. Building a management team, which in turn involves—
   1. Stressing the idea of a team approach to making decisions.
   2. Focusing on developing management skills.
   3. Emphasizing cross training.
   4. Developing a system of routine communication.
   5. Implementing routine, non-threatening evaluation.

B. The "power" issue, which involves the issue of who can control decision making. From a planning perspective, that involves—
   1. Needing to create an environment in which decision making power is secondary to quality of decision-making input.
   2. A "power audit" to focus upon decision making power under alternative scenarios.
   3. Consideration of the choice of organizational structure.

C. Assuring fair compensation is a fundamental part of a succession plan.
   1. It is important to compensate each individual fairly each year (salary, bonus, payment in equity interest in business).
   2. The hazards of deliberate under-compensation with intent of "someday" making it right are well known.

D. A succession plan should anticipate disruptions, such as—
   1. Premature retirement or death.
   2. Retirement or death at or near expected time.
   3. Dissolution of marriage and division of ownership in the business.
   4. Serious disagreements.
   5. Major tort or other liability.

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** Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University, Ames, Iowa; member of the Iowa Bar.
E. Valuing ownership interests is a key part of protecting owners, especially minority owners.

1. Several options are available—
   a. Book value.
   b. Appraisal.
   c. Periodically negotiated fixed price.
   d. Value set in a market.

2. Valuations may be subject to discounting—
   a. Minority interest,
   b. Non-marketability,
   c. Co-ownership,
   d. Potential income tax liability.

F. Protecting minority owners is important to younger generation individuals especially in corporations. Several basic options can be employed—

1. Assured market at fair price for ownership interest.
2. Carefully drafted provisions for triggering first option and buy-sell agreements.
3. Modification of traditional decision making rules—
   a. Super-majority vote.
   b. Below-majority vote.
   c. Pre-decide key issues (voting trust, pooling agreement, shareholders’ agreement).
   d. Cumulative voting.
   e. Pre-emptive rights.

G. Phased retirement focuses on encouraging older individuals to retire and may involve—

1. An appropriate level of compensation.
2. Access to retirement benefits and social security (particularly for those under age 65).
3. Development of a reduced-responsibility position on the management team.

II. Role of managers as agent

A. General rule — activities of an agent are imputed to the principal
1. Fifteen year installment payment of federal estate tax.

2. Income in respect of decedent.


4. Personal holding company tax and status of rent for the family-owned business deduction.

B. Rule for situations routed through I.R.C. § 1402 (imputation is blocked for those producing agricultural or horticultural products).

1. Rent as self-employment income.

2. Special use valuation of land for purposes of material participation.

3. Material participation for the family-owned business deduction.

C. Presence of paid manager or agent destroys the principal’s own record of involvement.

III. Special use valuation

A. How property is valued

1. In general, property subject to federal estate tax is valued at fair market value.

2. The executor may elect to value real property devoted to farming or other closely-held businesses at its special use or “use” value rather than fair market value. This valuation provision, however, cannot reduce the gross estate by more than $820,000 (for 2002), $840,000 for 2003. That figure is indexed for inflation beginning in 1999.

   a. If farmland qualifies, its value can be determined in two ways —

      (1) By capitalization of rent by dividing —

         (a) The average annual gross cash rental for comparable land used for farming purposes in the locality less property taxes for comparable land by

         (b) The average annual effective interest rate for all new Federal Land Bank loans.

         (c) The calculations are to use the five most recent calendar years ending before the date of the decedent's death.

         (d) “Net share rentals” can be used if there are no cash rented tracts of comparable land.

      (2) The rent capitalization approach is not to be used if there is no comparable land for determining average annual gross cash rental or if the executor elects to value the real property using the following factors (this is the only special use valuation method open to non-farm businesses) —

         (a) Capitalization of income that the property can be expected to yield over a reasonable period under prudent management.

         (b) Capitalization of the fair rental value.
(c) Assessed value if the state bases property tax assessments on current use.

(d) Comparable sales in the same geographical area but without significant influence from metropolitan or resort areas, and

(e) Any other factor that would fairly value the farm or closely-held business property.

b. To qualify for special use valuation, several conditions must be met before death —

(1) The value of the farm or other closely-held business assets must be at least 50 percent of the gross estate less indebtedness attributable to the property and that amount or more must pass by inheritance or purchase to qualified heirs. Qualified heirs can be any member of the decedent's family.

(a) For deaths after 1981, the term "member of the family" includes the ancestors, lineal descendants, spouse, lineal descendants of the spouse, lineal descendants of the parents of the individual and the spouse of any lineal descendant. For deaths before 1982, lineal descendants of grandparents were considered to be members of the family.

(b) The term "member of family" is important also in determining —

[1] Who are eligible material participators before and after death,

[2] Who can meet the qualified use test before death,

[3] Who can meet the ownership requirements before death, and


(c) Purchases of special use value land —

[1] If purchased from the estate, the estate does not recognize gain for income tax purposes except to the extent the fair market value on sale exceeds the fair market value at death. The purchasing heir's income tax basis is, ordinarily, the special use value. Resale by the purchasing heir, therefore, produces substantial amounts of gain.

[2] If the estate is settled and one qualified heir purchases from other qualified heirs, the selling heirs have taxable gain and the purchasing heir receives an income tax basis equal to the purchase price.

(2) At least 25 percent of the gross estate less secured indebtedness must be qualified farm or closely-held business real property.

(3) The property must be used in a “qualified use.” During the pre-death period, the decedent must have had an equity interest in the business operation.

(a) The qualified use test must be met by the decedent or a member of the family —

[1] At the time of death, and

[2] For five or more of the last eight years before death.

(b) In general, the position of IRS is that the qualified use test requires —
[1] At least a nonmaterial participation crop share lease except that cash rent leases to a family member as tenant are acceptable in the pre-death period.

[2] Cash rent leases to a partnership, corporation or other entity as farm tenant should qualify in the pre-death period if the entity is owned and controlled by family members.

(4) The real property must have been owned by the decedent or a family member and used or held for use as a farm or closely-held business for five or more of the least eight years prior to the decedent's death. For deaths after 1981, “tacking on” of ownership, qualified use and material participation requirements is permitted in the case of replacement property acquired in conjunction with a tax-free exchange or involuntary conversion.

(5) The decedent or member of the family must have participated materially in the operation of the farm or other business in at least five of the eight years preceding the earlier of the decedent's retirement, disability or death.

(a) For a surviving spouse (of a decedent who had held qualified real property) who received the property from the decedent, “active management” of the farm or other business substitutes for material participation. The term “active management” is defined as “the making of the management decisions of a business (other than the daily operating decisions).”

(b) As to material participation, the regulations specify that —

“No single factor is determinative of the presence of material participation, but physical work and participation in management decisions are the principal factors to be considered. As a minimum, the decedent and/or a family member must regularly advise or consult with the other managing party on the operation of the business. While they need not make all final management decisions alone, the decedent and/or family members must participate in making a substantial number of these decisions. Additionally, production activities on the land should be inspected regularly by the family participant, and funds should be advanced and financial responsibility assumed for a substantial portion of the expense involved in the operation of the farm or other business in which the real property is used. In the case of a farm, the furnishing by the owner or other family members of a substantial portion of the machinery, implements, and livestock used in the production activities is an important factor to consider in finding material participation.”

(c) For a farm, maintaining a residence on the premises (by the decedent or heir) is a factor in determining whether the material participation tests have been met.

(6) A qualified heir must receive a "present interest" in the property.

c. If the property is disposed of within 10 years after the death of the decedent to nonfamily members or ceases to be used for farming or other closely-held business purposes, the tax benefits are recaptured.

(1) Cessation of use occurs if there is absence of material participation for more than three years in any eight year period ending after death. The material participation requirement can be met by “active management” by a qualified heir who is a surviving spouse, person under age 21, disabled individual or full-time student. For those who are under 21 or disabled, a fiduciary (such as a conservator) can meet the active management test.

(2) Recapture occurs if the property was not used in a qualified use.

(a) Each qualified heir must have an equity interest in the business operation. Cash rent leases do not meet the test even if to family members except for
[1] Cash rent leases by a surviving spouse to a member of the surviving spouse's family.

[2] Cash rent leases by a lineal descendant of the decedent to a member of the lineal descendant’s family. The 2001 Act authorized refunds or credits for recapture tax paid, retroactive to 1976, for failure to meet the post-death qualified use test based on cash renting by a surviving spouse to a member of the surviving spouse’s family or by a lineal descendant to a member of the lineal descendant’s family. Claims for refund or credit must be filed within one year after enactment of the Act (June 7, 2001).

(b) There is a two year “grace period” immediately after death for meeting the qualified use test. To the extent the grace period is used, the recapture period is extended by a like period.

(3) Death of the qualified heir eliminates the possibility of recapture.

(4) Upon recapture a qualified heir may make an election to increase the income tax basis of the property to date of death fair market value (or as of six months after death) if interest is paid on the recaptured tax.

(5) Tax-free exchanges may occur without triggering recapture. Similarly, land may be replaced after condemnation or involuntary conversion without recapture of the use valuation benefits.

d. Special rules for land held by a trust, partnership or corporation.

(1) To be eligible, the decedent's interest—

(a) In a partnership (capital interest) must comprise 20 percent or more of the decedent's gross estate or the partnership must have 45 or fewer partners.

(b) In a corporation voting stock must comprise 20 percent or more of the decedent's gross estate or the corporation must have 45 or fewer shareholders.

(2) The decedent must also meet the test that at least 50 percent of the estate (less secured indebtedness) must be business real or personal property, owned directly or indirectly.

(3) The decedent must meet the test that at least 25 percent of the estate (less secured indebtedness) must be business real property.

(4) In general, it is believed that only pure equity ownership interests (where the value of the ownership interest changes as land values change) are eligible for special use valuation for land owned by the entity.

e. A special lien is imposed on the real property for which an election has been made to utilize special use valuation—

(1) The Treasury Department may subordinate the special lien to other obligations if sufficient collateral exists to protect adequately the Treasury's interest.

(2) The lien does not take priority over

(a) Real property taxes and special assessments for public improvements.

(b) Mechanic’s liens for repair or improvement of the property.
(c) Security interests for the construction or improvement of real property (to the extent of the real property involved in the improvement).

(d) A contract to construct or improve real property (to the extent of the proceeds of the contract).

(e) “The raising or harvesting of a farm crop or the raising of livestock or other animals” (to the extent of the crops or livestock involved and the property affected by the general lien for unpaid federal taxes).

IV. Family-owned business deduction

A. The family-owned business deduction

1. One of the most dramatic features of the Taxpayer Relief Act of 1997 was the creation of the “family-owned business exclusion.” The exclusion was transformed into a deduction in amendments enacted in 1998.

a. The deduction is available through 2003 to cover part or all of the value of a qualified family-owned business interest. Many farm and ranch operations with asset values exceeding what can be covered by the unified estate and gift tax credit should be able to qualify for the exclusion and will likely do so if the provision is repaired to resolve some problems.

b. In several respects, the pre-death and post-death requirements parallel those for special use valuation.

   (1) Unfortunately, the two provisions, both of which are likely to be important in farm and ranch estate and business planning, do not have identical requirements even though the rules are similar.

   (2) This will likely lead to some confusion over use of the two provisions.

c. It is important to approach special use valuation and the family-owned business deduction as separate and distinct concepts each with unique pre-death requirements for eligibility and post-death requirements to avoid repayment or recapture of the benefits involved.

d. One major difference between special use valuation and the family-owned business deduction is that special use valuation applies only to land and contains detailed rules on how eligible land is to be valued for federal estate tax purposes.

   (1) The family-owned business deduction, by contrast, is applicable to all assets used in the farm or other closely held business. Thus, machinery, equipment, livestock, stored grain and cash needed in the business are eligible for the deduction.

   (2) The assets involved are valued at fair market value in the traditional manner.

   (3) Up to the available amount for the year of death, the assets are deducted from the federal estate tax gross estate.

2. Amount of the family-owned business deduction.

   a. The amount of the family-owned business exclusion as originally enacted—
(1) The unified credit “applicable exclusion” amount was subtracted from the $1.3 million. Therefore, for deaths in 1998, the applicable exclusion amount from the unified credit was $625,000. The FOBE would have been $1,300,000 - 625,000 or $675,000.

(2) As the applicable exclusion amount increased (through 2006) to the $1,000,000 level, the FOBE dropped from $675,000 to $300,000.

Figure 1 shows the relationship of the applicable exclusion amount and the family-owned business exclusion (FOBE) as originally enacted from 1998 through 2006.

Figure 1. Unified credit and family-owned business exclusion (as originally enacted)

<table>
<thead>
<tr>
<th>Year</th>
<th>Family-Owned Business Exclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>$625,000</td>
</tr>
<tr>
<td>1999</td>
<td>$650,000</td>
</tr>
<tr>
<td>2000</td>
<td>$675,000</td>
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<tr>
<td>2005</td>
<td>$950,000</td>
</tr>
<tr>
<td>2006</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>&amp; later</td>
<td></td>
</tr>
</tbody>
</table>

b. As amended in 1998

(1) The maximum family-owned business deduction (FOBD) is $675,000 in 1998 and continues at that level through 2003.

(2) The applicable exclusion amount was $625,000 for deaths in 1998 and does not increase thereafter.

(3) Thus, the total amount passing under the two concepts is $1,300,000 per year for years after 1997.

(4) If an estate includes less than $675,000 of qualified family-owned business interests, the applicable exclusion amount (which is available to all decedents) is increased on a dollar-for-dollar basis but only up to the applicable exclusion amount otherwise available for the year of death.

(5) The family-owned business deduction applies only for federal estate tax purposes and is not available for federal gift tax or generation skipping transfer tax purposes.

Figure 2. Family-owned business deduction

<table>
<thead>
<tr>
<th>Year</th>
<th>Family-Owned Business Deduction</th>
<th>Applicable Exclusion Amount</th>
</tr>
</thead>
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<tr>
<td>1998</td>
<td>$675,000</td>
<td>$625,000</td>
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<tr>
<td>1999</td>
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<tr>
<td>2006</td>
<td>$1,000,000</td>
<td>$625,000</td>
</tr>
<tr>
<td>&amp; later</td>
<td></td>
<td>$625,000</td>
</tr>
</tbody>
</table>

3. Requirements for eligibility
a. Several requirements must be met for estates to be eligible for the FOBD. These requirements are expected to be scrutinized as carefully as have the requirements for special use valuation over the past 20 years.

(1) The decedent or a member of the decedent's family must have materially participated in the trade or business for at least five of the eight years preceding the decedent’s death. Note that, for special use valuation purposes, the requirement was changed in 1981 to five or more years before the earlier of retirement, disability or death.

(a) Also, the decedent or member of the decedent's family must have owned the family-owned business interest or interests for five or more of the last eight years before the decedent’s death.

(b) In farm and ranch businesses, at least in a sole proprietorship where no entity is involved, substantial amounts of personal property (particularly machinery, livestock and stored grain) may not have been held by the decedent or member of the family for the minimum five-year period.

(2) The decedent must have been a U.S. citizen or resident at the time of death and the principal place of business must be in the United States.

(3) The executor or personal representative must elect to use the FOBD and file an agreement of personal liability for possible “recapture” or repayment of the tax benefits.

(4) The aggregate value of the decedent’s qualified family-owned business interests must exceed 50 percent of the adjusted gross estate (gross estate less allowable deductions).

(a) To ascertain whether the decedent’s “qualified family-owned business interests” make up more than 50 percent of the decedent’s adjusted gross estate, a calculation is used involving a numerator and a denominator.

[1] The numerator includes the aggregate of all qualified family-owned business interests that are includible in the decedent’s gross estate and are passed from the decedent to a qualified heir, plus any lifetime transfers of such interests by the decedent to members of the decedent’s family (other than the decedent’s spouse), if those interests have been held continuously by members of the family and were not otherwise includible in the gross estate. For this purpose transferred interests are valued as of the date of the transfer. That amount is reduced by the value of claims and mortgages under I.R.C. § 2053(a)(3), (4) less that on a qualified residence, indebtedness incurred to pay educational or medical expenses of the decedent, spouse or dependents and any other indebtedness up to $10,000.

[2] The denominator is the gross estate of the decedent reduced by estate indebtedness and increased by lifetime transfers of qualified business interests made by the decedent to members of the decedent’s family (other than the spouse) if the interests were held continuously by members of the family, plus transfers (other than de minimis transfers) from the decedent to the spouse within 10-years of death plus any other transfers made by the decedent within three years of death except for non taxable transfers made to members of the decedent’s family.

(b) In meeting this test, land valued under special use valuation is valued for FOBD purposes the same way.
(c) The qualified family-owned business interests, which must make up more than 50 percent of the decedent’s adjusted gross estate as noted above, must pass to or be acquired by qualified heirs to the extent of that 50 percent figure or more.

(d) This is a critical requirement and means that any post-death sale of business assets should be considered carefully with an eye to whether a sale would jeopardize eligibility for the family-owned business deduction.

(5) “Qualified use” or “business” test

(a) There is no “qualified use” test as such as under special use valuation.

[1] That test requires, in the pre-death period, that the decedent or member of the decedent’s family be “at risk.”

[2] It is pointed out that the qualified use test emerged in IRS regulations four years after enactment of special use valuation based upon language in the statute requiring the property to be devoted to “use as a farm for farming purposes or use in a trade or business of farming.”

[3] The inclusion in the special use valuation statute of the term “…trade or business of farming” gave rise to the qualified use test.

(b) The family-owned business deduction also requires the existence of a “trade or business.”

[1] Passive assets are not eligible for the exclusion—

[a] Those producing interest, dividends, rents, royalties, annuities and personal holding company income;

[b] Assets in a trust, partnership or real estate mortgage investment conduit (REMIC) that are not in an active business;

[c] Assets producing no income;

[d] Assets giving rise to income from commodities transactions or foreign currency gains;

[e] Assets producing income equivalent to interest; and

[f] Assets producing income from notional principal contracts or payments in lieu of dividends.


[a] A cash rent lease to a member of the decedent's family as tenant is acceptable in the pre-death period.

[b] A cash rent lease to a family-owned entity as tenant pre-death is presumed to meet the requirements.

[c] A share lease is believed to meet the test.
Although, the FOBD rules do not contain a “qualified use” test or “at risk” requirement as such, the provision does specify that the two-year “grace period” rules under special use valuation are to apply to the FOBD. In the context of special use valuation, the two-year grace period only applies to the qualified use test.

The decedent or member of the decedent’s family must have owned the family-owned business interest or interests for five or more of the last eight years before death. This requirement will be difficult to meet for assets such as grain, livestock and machinery.

The decedent or a member of the decedent’s family must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent’s death.

(a) For purposes of FOBD, material participation is required by the decedent or member of the decedent’s family for five or more of the last eight years preceding the decedent’s death.

(b) It is important to note that material participation cannot be achieved through an agent under the special use valuation rules. The same limitation applies to the family-owned business deduction.

(c) The meaning given the term “material participation” for purposes of FOBD is the same as for special use valuation (but the time requirements for eligibility are not the same).

1 The Senate Finance Committee report states that “…an individual generally is considered to be materially participating in the business if he or she personally manages the business fully, regardless of the number of hours worked, as long as any necessary functions are performed.”

2 This committee report language is substantially less demanding than is required for material participation under special use valuation as the FOBD statute states is to be used as the guide on what constitutes material participation.

3 A question is raised as to whether the committee report language can be relied upon.

(d) The Senate Finance Committee report states that “if a qualified heir rents qualifying property to a member of the qualified heir’s family on a net cash basis, and that family member material participates in the business, the material participation requirement will be considered to have been met with respect to the qualified heir for purposes of this provision.”

1 That language seems to support the position that the presence of a cash rent lease does not preclude a finding of pre-death material participation.

2 However, as noted above, cash rent leasing to an unrelated tenant may be inconsistent with the “trade or business” requirement, both pre-death and post-death.

4. Meaning of “qualified family-owned business interest”

a. This is an important term in FOBD and one of the “gates” to keep mere investors from trying to gain eligibility.

b. A “qualified family-owned business interest” includes an interest as a proprietor in a business carried on as a proprietorship or an interest in an entity carrying on a business if at least 50 percent of the entity is owned, directly or indirectly, by the decedent or a member of the decedent’s family.
(1) An interest in a business qualifies if 70 percent of the entity is owned by members of two families (and at least 30 percent is owned by the decedent or members of the decedent’s family).

(2) Similarly, an interest in a business qualifies if 90 percent of the entity is owned by members of three families (and at least 30 percent is owned by the decedent or members of the decedent’s family).

c. In applying the ownership test in a corporation, the decedent and members of the decedent’s family must own the required percentage of the total combined voting power of all classes of stock entitled to vote and the required percentage of the total value of all shares of stock of the corporation. For a partnership, the decedent and members of the decedent’s family must own the required percentage of the capital interest in the partnership. The Senate Committee report states that the required percentage must be held of the profits interest, also.

d. In the case of entities in which a trade or business owns an interest in another trade or business, a “look-through” test is employed with each trade or business owned by the decedent and members of the decedent’s family separately tested to determine whether that trade or business meets the requirements of a qualified family-owned business interest.

(1) Any interest that a trade or business owns in another trade or business is disregarded in determining whether the first trade or business is a qualified family-owned business interest.

(2) The value of any qualified family-owned business interest held by an entity is treated as owned proportionately by or for the entity’s partners, shareholders or beneficiaries.

e. A trade or business does not qualify for FOBD if the stock or securities of the business were publicly traded at any time within three years of the decedent’s death.

f. Other than for banks and domestic building and loan associations, an interest in a trade or business does not qualify if more than 35 percent of the adjusted gross income of the business for the year of the decedent’s death was personal holding company income—rents, interest and dividends, for example.

5. Excess cash

a. The value of a trade or business for purposes of FOBD is reduced to the extent the business holds passive assets or excess cash or marketable securities.

b. The value of a qualified family-owned business interest does not include any cash or marketable securities in excess of the reasonably expected day-to-day working capital needs of the trade or business.

c. The Senate Finance Committee report acknowledges that the Bardahl formula approach (Bardahl Mfg. Corp., T.C. Memo. 1965-200), may be used in making the determinations. The same approach is now accepted in calculating the interest in a closely-held business for purposes of installment payment of federal estate tax.

6. Member of family

a. The term “member of family” is used throughout the FOBD statute and has the same meaning as for purposes of special use valuation.
b. That definition includes the individual’s spouse; lineal ancestors; lineal descendants of the individual, the individual’s spouse and the individual’s parents; and the spouse of lineal descendants.

7. Qualified heir

a. The term “qualified heir” defines the group of eligible individuals to receive interests in a qualified family-owned business.

b. The term is defined as under special use valuation and includes members of the decedent’s family who acquired the property (or to whom the property passed) from the decedent.

c. In addition, for purposes of FOBD, the term “qualified heir” includes an “active employee of the trade or business to which the qualified family-owned business interest relates if such employee has been employed by such trade or business” for at least 10 years before the decedent’s death.

8. Recapture rules

a. Establishing eligibility for the family-owned business deduction is only half of the battle. There’s also a set of requirements in the after-death period to avoid repayment or “recapture” of the benefits from the provision.

b. The family-owned business deduction rules levy a recapture tax if, within 10 years of the decedent’s death and before the qualified heir’s death, a recapture event occurs. Recapture is triggered by any one of several events—

(1) Absence of material participation by the qualified heir or a member of the qualified heir’s family for more than three years in any eight year period ending after death causes recapture.

   (a) The rules specify that the provisions applicable to special use valuation which allow active management to substitute for material participation for some qualified heirs apply also to FOBD.

   (b) That includes surviving spouses, full-time students, those under age 21 and those who are disabled. Members of that group can get by with “active management” which requires less involvement than material participation.

   (c) The meaning given the term “material participation” for purposes of the family-owned business deduction is the same as for special use valuation in the post-death period.

[1] As noted above, the Senate Finance Committee report states—

   “...an individual generally is considered to be materially participating in the business if he or she personally manages the business fully, regardless of the number of hours worked, as long as any necessary functions are performed.”

[2] That language is hardly consistent with the statutory mandate to use the special use valuation definition of the term. Where committee report language and the statute are in conflict, the committee report language is usually disregarded.

(2) “Qualified use” or “business” test

   (a) The legislation incorporates the two-year “grace period” from special use valuation. For special use valuation purposes, the two-year grace period immediately following death applies only to excuse the estate or qualified heirs from meeting the “qualified use” or “at risk” test. It has no application to material participation.
(b) The family-owned business deduction rules do not explicitly include a qualified use or at risk test.

[1] But the widespread use of the term “business” throughout the statute and the presence of the “passive asset” rule clearly indicate that Congress contemplated that a business be carried on.

[a] That is one possible interpretation of the incorporation of the two-year grace period into FOBD.

[b] With that interpretation, the requirement of a “business” is waived during the two-year period after death and the 10-year recapture period is extended for a like time. This interpretation harmonizes with the statute and is believed to be the correct interpretation.

[2] The other possible interpretation is that the two-year grace period is intended to allow a two year lapse in material participation immediately following death. The problems with that interpretation are—

[a] The post-death material participation rule already allows a three year lapse; and

[b] This interpretation would be inconsistent with material participation for special use valuation purposes which would be contrary to the FOBD statute.

(c) Although the family-owned business deduction statute does not define “trade or business” or refer to a code provision where the term is defined, the term generally requires continuity and regularity of activity and that the owner or owners be bearing the risks of production and the risks of price change.

[1] Although it is not completely free from doubt, the 1998 amendment makes it reasonably clear that the "trade or business" requirement is met if the assets are used by any member of the qualified heir's family.

[2] This suggests that cash rent leases of land post-death are acceptable if rented to a member of the qualified heir’s family as tenant or to an entity owned by members of the qualified heir's family.

(d) Recapture is triggered if the qualified heir disposes of a portion of a qualified family-owned business interest other than to a member of the qualified heir’s family, an entity owned by members of the qualified heir’s family or through a qualified conservation contribution.

[1] As drafted, the family-owned business deduction rules do not contain an exception to post-death recapture for sales or exchanges of crops or livestock held for sale or for property used in the business (such as machinery, equipment, dairy animals or breeding stock). Thus, as the statute is now worded, a sale of a corn crop or of cull cows would trigger recapture consequences unless sold to a member of the family or a family-owned entity. Similarly, a sale or trade of machinery or equipment would cause recapture. The same outcome would be expected from the sale of inventory of a nonfarm sole proprietorship.

[2] Language in the conference committee report (which was added at the last minute when this problem was called to the attention of Senate Finance Committee staff members) supports the view that sales or exchanges of grain or livestock in inventory
and sales or exchanges of assets used in the business (other than land) in the course of business should not lead to recapture—

“The conferees clarify that a sale or disposition, in the ordinary course of business, of assets such as inventory or a piece of equipment used in the business (e.g., the sale of crops or a tractor) would not result in recapture of the benefits of the qualified family-owned business exclusion.”

[3] With no statutory provision providing support for that statement, however, a question is raised whether language in the conference committee report will be sufficient. An amendment to the statute will likely be necessary to resolve the matter.

(e) The recapture rules for the family-owned business exclusion phase down the recapture tax based on the number of years of material participation.

<table>
<thead>
<tr>
<th>Recapture event occurring in following year of material participation</th>
<th>Percentage of Recapture Tax Due</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 through 6</td>
<td>100</td>
</tr>
<tr>
<td>7</td>
<td>80</td>
</tr>
<tr>
<td>8</td>
<td>60</td>
</tr>
<tr>
<td>9</td>
<td>40</td>
</tr>
<tr>
<td>10</td>
<td>20</td>
</tr>
</tbody>
</table>

[1] It is pointed out that the provision is ambiguous in that it uses “year of material participation” to calculate the recapture tax. Lapses in material participation in the post-death period are allowed without recapture for up to three years (absence of material participation for more than three years in any eight year period ending after death triggers recapture).

[2] Moreover, if the second possible interpretation of the presence of the two-year “grace period” (as discussed above) prevails, that would add two more years of possible non material participation. This ambiguity should be resolved.

(3) Recapture is also caused if the qualified heir loses U.S. citizenship or the principal place of business of the family-owned business interest ceases to be located in the United States.

c. Under the family-owned business deduction rules, recapture is apparently calculated on a proportionate basis in the event of a partial disposition. Note: property may be subject to recapture even though not included in the election for the family-owned business deduction.

(1) The amount of the recapture tax is based on the value of all qualified family-owned business interests, at least those listed for purposes of the 50 percent test, not the amount for which the election was filed.

(a) The “adjusted tax difference” attributable to a qualified family-owned business interest is the amount bearing the same ratio to the adjusted tax difference with respect to the estate as the value of the interest bears to the value of all qualified family-owned business interests.

(b) The term “qualified family-owned business interests” is defined as interests which are included in determining the value of the gross estate and are acquired by a qualified heir.

(c) Therefore, if some assets are included in the qualified family-owned business interest for purposes of meeting the 50 percent test, but are not specifically elected for the deduction, disposition of the non-elected assets would appear to trigger recapture consequences nonetheless.
(d) While regulations have not yet been issued for the family-owned business deduction provision, no rulings have been issued and no cases have been litigated to courts of record, the recapture form, Form 706-D, is consistent with this conclusion.

(1) Line 2 of Form 706-D requires the “total reported value of qualified family-owned business interests (from line 6, Schedule T, of the decedent’s estate tax return)” to be compared with the “qualified heir’s share of the total qualified family-owned business interests” in line 1.

(2) Line 6 of Schedule T to Form 706 requires the “total reported value” of all qualified family-owned business interests “reported on this return.”

(3) The net value of qualified family-owned business interests elected for the deduction is listed in line 15 of Schedule T, after the 50 percent test has been met.

(4) The recapture calculations make no reference to the line 15 amount which represents the amount specifically subjected to the FOBD election.

d. The FOBD statute imposes interest in the event of recapture from the time the federal estate tax is originally due until the time the additional estate tax is paid.

(1) The “additional estate tax” is due six months after the recapture event.

(2) Beyond the due date, interest at the regular rate on unpaid tax is due on the recapture tax.

e. The FOBD statute contains rules drawn from special use valuation allowing tax-free exchanges (without triggering recapture) and allowing reinvestment of proceeds received in an involuntary conversion without recapture.

f. FOBD contains three provisions regarding acceleration of payment of federal estate tax.

(1) Section 303 stock redemptions do not cause acceleration (presumably, under FOBD do not cause recapture).

(2) Type D, E, or F corporate reorganizations do not cause acceleration (presumably, do not cause recapture).

(3) Transfers at death to a member of the family are not an acceleration (or recapture) event.

9. Election

a. The FOBD statute contains rules drawn from special use valuation for purposes of making the election and filing the agreement of personal liability. The election is made on Schedule T of Form 706.

b. Several other provisions including authority for a special lien for the additional estate tax are also included.

10. Other considerations

a. The enactment of the family-owned business deduction raises several questions in a planning context. A few are discussed below; others will almost certainly arise.

(1) For those with assets exceeding $1,300,000, can part or all of the land be valued under special use valuation with the remaining assets passing under the family-owned business deduction? Or will it be necessary to keep the land (for which special use valuation is desired) outside of
the business and rent the land to the business? It appears that land can be subjected to special use valuation with the rest of the assets included in a FOBD election.

(2) One effect of the family-owned business deduction is to discourage farmers and others with small businesses from building up savings. Savings beyond the reasonable needs of the business aren’t eligible for the tax break involved. The provision, especially for older farmers, will encourage individuals to remain fully invested in land and other assets. Sale of land before death will be discouraged. Land sales on contract will be discouraged inasmuch as a land contract is unlikely to be considered a business asset, at least in a sole proprietorship.

(3) The family-owned business deduction will be viewed widely as an attractive way to shelter assets. Because of the ready availability of tenants to operate farms under crop share leases in almost all areas of the country, investments in farmland are likely to be viewed with particular favor. If the material participation test can be met by a member of the family, as is permitted, or if the Senate Finance Committee language is accepted by IRS, the barriers to eligibility will be modest provided the “trade or business” makes up more than 50 percent of the decedent’s adjusted gross estate. This could mean increased investment in farmland by older taxpayers and higher farmland prices.

b. The statute will need to be amended further for the provision to be useful.

11. The provision is effective for deaths after December 31, 1997, but has been repealed for deaths after 2003.

V. Installment payment of federal estate tax

A. Rises in real estate values in the 1970s and increases in other assets per firm as death tax exemptions and rates remained nearly constant made more estates subject to federal estate and state inheritance taxes than formerly. Commencing in 1977, small and medium sized estates have experienced some reduction of federal estate tax burden with further significant reductions from legislation enacted in 1981 phased in over six years. Reductions in land values in the 1980’s lessened the potential death tax liability for many estates. However, liquidity to provide for debts of the decedent has become a major concern.

B. It may be helpful to develop a liquidity plan as part of the overall estate plan—

1. The liquidity plan represents a conscious effort to select the most appropriate techniques for solving the liquidity problem and includes—

   a. A realistic assessment of the liquidity needs at the deaths of both spouses, in the case of a married couple, or the deceased alone in the case of a single individual.

   b. A review of all feasible liquidity augmenting techniques available including sale of inventory, sale or mortgage of land, life insurance, savings, installment payment of federal estate tax, flower bonds and stock redemptions.

   c. Selection of the most economically advantageous of the alternatives.

   d. A listing of all pre-death requirements that must be met for eligibility of the selected techniques.

C. Several provisions may be used to augment liquidity.

1. "Fifteen year" installment payment of federal estate tax.
a. An installment payment provision is available for federal estate tax attributable to a closely-held business. Interest only need be paid for the first five years after the due date for the federal estate tax return with the tax paid in two to ten annual installments thereafter with interest on the unpaid balance beginning 69 months after death.

b. Interest rate

(1) For the first $345,800 of tax less the allowable unified credit (the tax on $1,000,000 of taxable estate) the interest rate was 4 percent (compounded daily) for deaths through 1997. Interest on additional amounts was due at the regular rate.

(2) For deaths after 1997, the interest rate on the first $1,000,000 of taxable estate (inflation adjusted to $1,100,000 in 2002, $1,120,000 in 2003), above the applicable exclusion amount ($1,000,000 in 2002) is two percent with interest above that set at 45 percent of the quarterly federal rate for underpayments of federal tax. No deduction is allowed for interest on deferred federal estate tax either for income tax or estate tax purposes.

c. To be eligible—

(1) The decedent must have had an “interest in a closely-held business” (Tier I test)—

(a) For a partnership, 20 percent or more of the total capital interest in the partnership must be included in the estate or the partnership must have 45 or fewer partners (15 or fewer partners before 2002).

(b) For a corporation, 20 percent or more of the corporation's voting stock must be in the decedent's estate or the corporation must have 45 or fewer shareholders (15 or fewer shareholders before 2002).

(c) For a sole proprietor, the interest in the sole proprietorship counts.

(d) For leased property, mere passive rental arrangements with payment of cash rent do not qualify but lease arrangements (such as crop or livestock share leases) with active involvement in management by the decedent or the decedent's agents or employees constitute an interest in a closely held business.

(e) “Passive assets” (mainly assets not used in the business) held by any business are disregarded for purposes of eligibility and for purposes of figuring the amount of federal estate tax that may be deferred. However, legislation in 2001 allows five-year installment payment for “lending and financing” businesses which includes leasing real and personal property.

(2) The interest in the closely held business must make up more than 35 percent of the adjusted gross estate (Tier II test)—

(a) For a corporation, corporate stock meets the requirement.

(b) For a partnership, the partnership capital interest is eligible.

(c) For a sole proprietor, the interest in the sole proprietorship counts toward the 35 percent.

(d) Assets under an active lease arrangement may be applied toward the 35 percent amount.
(3) Businesses held by holding companies may be eligible for installment payment of federal estate tax if the stock is not readily tradable. However, the four percent interest rate and five year deferral of the principal amount of tax are not available.

d. For purposes of the 35 percent requirement, interests in residential buildings and related improvements which are occupied on a regular basis by (1) the owner, (2) lessee or (3) by persons employed by the owner or lessee for purposes of operating or maintaining the property can be included.

e. After death, except for “Section 303” redemptions, testamentary transfers by the decedent and certain corporation reorganizations, if one-half or more of the interest in the closely-held business is distributed, sold, exchanged or otherwise disposed of or is withdrawn from the business, the remaining installments become due.

(1) Transfers involving the decedent's interest in a closely held business at the death of the original heir—or at the death of any subsequent transferee—do not accelerate federal estate tax payment if each subsequent transferee is a family member of the transferor.

(2) Mere changes in organizational form or tax-free exchanges of property do not accelerate installment payment.

(3) Mortgaging the property in the post-death period likewise does not accelerate the payment if funds are used to pay the costs of refinancing and liens.

(4) Cash renting of assets is considered as a disposition of the assets.

(5) Execution of an oil and gas lease is not a disposition but interruption of the surface use is a disposition.

(6) Sale of property, even to family members, is considered to be a disposition.

(7) The transfer of property from an individual debtor to the bankruptcy estate under either Chapter 7 or 11 bankruptcy is not a disposition.

f. Participation in government acreage diversion programs apparently does not make the land ineligible for installment payment of federal estate tax.

g. A procedure is available for obtaining discharge of the fiduciary from responsibility for payment of tax.

(1) An estate representative seeking discharge from liability, may file an agreement giving rise to a special estate tax lien. The lien is authorized (but apparently not required) if 15-year installment payment has been elected.

(2) The lien is against “real and other property” expected to survive the deferral period. The maximum amount of property subject to the lien is the amount of deferred tax plus the first four years' interest. A bond may be accepted as to any excess liability.

(3) Once filed, the lien constitutes a priority claim against the property as against subsequent claimants with several exceptions. The special lien does not take priority over—

(a) Real property tax and special assessment liens.

(b) Mechanic’s liens for repair or improvement of real property.
(c) “Real property construction or improvement financing” agreements to finance—

[1] The construction or improvement of real property,

[2] A contract to construct or improve real property, or

[3] The “raising or harvesting of a farm crop or the raising of livestock or other animals.”

2. If the District Director of Internal Revenue finds reasonable cause for deferring federal estate tax on the due date (nine months after death) the time of payment may be extended for a maximum of ten one-year periods. Interest at the regular rate is paid on the unpaid balance.


   a. A redemption of corporate stock meeting the requirements of I.R.C. Section 303 is eligible for capital gain treatment of any gain involved for redemption of stock to pay death taxes, estate settlement costs and funeral expenses.

   b. The value of stock included in the decedent's estate must exceed 35 percent of the gross estate less allowable deductions. Stock of two or more corporations can be counted toward the 35 percent requirement if the decedent's gross estate included 20 percent or more of the outstanding stock of each corporation.

   c. Generally, redemption must be completed within 48 months after death except that redemption can continue over the 15-year period for installment payment of federal estate tax if elected.

4. United States treasury bonds of certain issues outstanding on March 3, 1971, may be applied in payment of the federal estate tax owed. Eligible bonds are redeemable at par which may be higher than the purchase price.

   a. The par value or market value, whichever is higher, plus accrued interest, is subject to federal estate tax. In most states, the traded value at death is subject to state inheritance tax. In a few, the par value is taxed.

   b. Such “flower bonds” receive a new income tax basis at death.

VI. Funding revocable living trusts

   A. The trust is an instrument whereby management, control and legal title to property are placed in the hands of a trustee for the benefit of specified beneficiaries—

      1. The trust instrument contains rules for trust operation and powers of the trustee. Together with applicable state law, the trust instrument is the basic governing document for the trust.

      2. The trust instrument often specifies the names of individuals who are to receive the income from the trust property and the names of the individuals who are to receive the principal of the trust upon dissolution.

      3. The trustee can be a member of the family, a corporate trustee, someone close to the family or other competent individuals. A trustee is entitled to receive compensation for services rendered.

   B. Types of trusts —
1. Trusts created during life (living or inter vivos trusts)—

   a. Revocable living trust—the grantor creates the trust by executing a trust agreement and funds the trust by transferring property to the trust during his or her life—

   (1) The grantor retains the power to amend, modify or revoke the trust. The revocable living trust becomes irrevocable at death. Frequently, the grantor retains the right to receive the income for life.

      (a) The trust frequently specifies that the property will remain in the trust for the lifetime of the surviving spouse and is ultimately distributed to children, charitable organizations or others at the death of the surviving spouse.

      (b) A revocable living trust is often accompanied by a “pour over” will to add to the trust assets not held in the trust at the time of death. The grantor frequently executes a “durable power of attorney” for financial matters to allow the holder of the power to transfer assets into the trust prior to death in the event of incompetency.

      (c) In general, it is believed advisable for the spouses to have separate trusts although one trust is sometimes used for both individuals—

         [1] With separate trusts, each can exercise the power to revoke as they see fit. With a joint or combined trust, problems can arise if one wishes to revoke and the other does not. That problem can be complicated if one is incompetent. Also, with separate trusts each can continue to hold the power to revoke their own trust without difficulty after the death of the other spouse.


         [3] Using separate trusts encourages the individuals to deal specifically with joint tenancy property.

         [4] In community property states, using a single trust for husband and wife may be advantageous in terms of maintaining community property status and obtaining a new income tax basis at the death of the first spouse to die on all of the property.

      [d] If real estate is involved, the trust is often acknowledged so that the trust can be recorded later in the county where the real estate is located. The concern is the establishment of good and merchantable title to the land.

   (2) Because of the powers retained by the grantor over the trust, the property in the trust is subject to the federal estate tax.

   (3) A revocable living trust only becomes operational upon the transfer of assets to the trust.

      (a) If an objective of the revocable living trust is to minimize estate settlement costs, all property of the grantor who creates the trust must be transferred into the trust before death unless the property is to pass upon death under a beneficiary designation or a right of survivorship.

      (b) The transfer should be handled as any other formal transfer for real estate, stocks, bonds, certificates of deposit, vehicles and other property.
(c) Some individuals may have problems of a psychological nature in transferring property to a trust even though the trust is revocable.

(4) Funding the revocable living trust—

(a) Transferring the residence to a trust does not make the residence ineligible for the $250,000 exclusion ($500,000 on a joint return) if the trust beneficiary is considered to be the “owner” of the residence, but may preclude claiming a property tax exemption or credit for the homestead in some states.

(b) Expense method depreciation does not apply to trusts (except possibly for grantor trusts). Cost recovery deductions are apportioned between trustee and income beneficiaries as income is allocated.

(c) If flower bonds are held in trust, the trust should terminate in favor of the decedent's estate or the trustee should be required to pay the decedent's federal estate tax.

(d) Transfer of business property subject to installment payment of federal estate tax could terminate installment payment unless it is a mere change in organizational form.

(e) Series E savings bonds could be transferred without causing recognition of gain as to accrued interest and the election to report the interest as income on the decedent's final return is still available.

(f) Installment contracts and other obligations may generally be transferred without accelerating recognition of gain unless the obligor is a trust beneficiary.

(g) Stock in an S corporation can be held in a “grantor” trust for up to two years after death.

(h) The ordinary loss deduction for “Section 1244” corporate stock is not available for stock disposed of by a trust (other than, possibly, for grantor trusts).

(i) In some instances, conveyance of encumbered property could accelerate the due date for the indebtedness.

(5) Reasons for a revocable living trust

(a) An important reason during life is to provide for management of property in the event of incompetency, problems of a physical nature or the desire to have someone else manage the assets.

[1] If the grantor who creates the trust serves as trustee initially, care should be taken to provide for a successor trustee or trustees in the event of incompetency, death or resignation of the trustee.

[2] A revocable living trust may be used to avoid the necessity of appointment of a conservator in the event of incompetency.

(b) The use of revocable living trust may, if used properly, help to simplify estate settlement after death.

[1] Estates are probated formally for three reasons—

[a] To determine who is to receive the property.
[b] To obtain good title to the property,
[c] To pay the taxes.

[2] With a revocable living trust, several steps are still necessary—
[a] Prepare and file an inventory of assets.
[b] Prepare and file the decedent's final state and federal income tax returns.
[c] Prepare and file the trust state and federal income tax returns with schedules K-1.
[d] Prepare and file a state inheritance tax return and obtain clearance (where necessary).
[e] If required, prepare and file federal estate tax return and obtain clearance.

(6) A revocable living trust can be used to avoid ancillary probate where real property is owned in another state. Avoidance of ancillary probate may also be possible with—
(a) Joint tenancy ownership (at the death of the first to die).
(b) Corporations.
(c) Partnerships.

(7) Arguably, there is more privacy with a revocable living trust than with a will although—
(a) The probate inventory must disclose assets.
(b) The trust instrument itself (or at least portions of the trust instrument) may have to be recorded to establish marketable title to real estate.

(8) Income tax status and requirements—
(a) A revocable living trust is treated as a “grantor trust” with all trust income taxable to the grantor.
(b) A fiduciary income tax return, Form 1041, is required to be filed if the grantor who created the trust is not the trustee. So long as the grantor is also the trustee, a Form 1041 is not required to be filed.
(c) For a trust where the same individual is both grantor and trustee and is treated as the owner of all assets of the trust, it is not necessary to obtain a taxpayer identification number for the trust. Otherwise, the trust must obtain a taxpayer identification number.

b. Irrevocable living trust—the grantor creates the trust by executing a trust instrument and funds the trust by transferring property to the trust during his or her life—

(1) The grantor gives up all control and power over the trust or trust property. Thus, a transfer of property involves a completed transfer by gift. Typically, the trust income is accumulated or paid to beneficiaries designated in the trust instrument. The grantor is not, usually, an income beneficiary.
(2) If the grantor relinquishes all control over the property and does not retain a right to the income, the value of the property should not be includible in his or her estate for federal estate tax purposes.

C. “Family estate” trusts or “pure” trusts that promise to solve all of an individual’s estate planning problems should be approached with caution—

1. Assignment of “lifetime services” to the trust is ineffective to shift the income tax liability to the trust.

2. The value of the property involved is taxed in the estate of the person who established the trust and who usually retains control over the trust.

3. The trust may be taxed as a corporation for income tax purposes.

4. Generally, creation of such a trust does not involve a taxable gift.

D. Fiduciary duty—a high degree of fiduciary care is imposed on trustees. This limits their discretion and affords protection to the beneficiaries. Within limits, the powers of trustees may be enlarged in the trust instrument.