Current Issues in Farm Tax Planning

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SMALL BUSINESS AND WORK OPPORTUNITY TAX ACT OF 2007

General Provisions

Family Business Tax Simplification

Act § 8215; I.R.C. § 761

Effective for tax years beginning after 2006

Background

A partnership is defined in I.R.C. § 7701(a)(2) as including a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation or venture is carried on, and which is not a trust or estate or a corporation. A partnership is treated as a pass-through entity, and income earned by the partnership, whether distributed or not, is taxed to the partners.

The income of a partnership and its partners is determined under Subchapter K of the Internal Revenue Code. Partnerships that meet specified criteria may elect not to be subject to the rules of Subchapter K. An eligible partnership may be formed for investment purposes only or for the joint production, extraction, or use of property but not for selling services or property produced or extracted).

An individual's self-employment income is subject to self-employment tax. If an individual is a partner in a partnership, net earnings from self-employment include his or her distributive share of income or loss from any trade or business carried on by the partnership.

Explanation of Change

A qualified joint venture whose only members are a husband and wife filing a joint federal income tax return is not treated as a partnership for federal tax purposes. A qualified joint venture is a joint venture involving the conduct of a trade or business, if all of the following apply:

- The only members of the joint venture are a married couple,
- Both spouses materially participate in the trade or business, and
- Both spouses elect to have the provision apply.

All items of income, gain, loss, deduction and credit are divided between the spouses in accordance with their respective interests in the venture. Each spouse takes into account his or her respective share of these items as a sole proprietor, accounting for his or her respective share on the appropriate form, such as Schedule C (Form 1040). The Joint Committee on Taxation reported that the provision is not intended to change the determination of whether an entity is a partnership for federal tax purposes without regard to this election.

In determining net earnings from self-employment, each spouse's share of income or loss from a qualified joint venture is taken into account just as it is for federal income tax purposes under the provision (i.e., in accordance with their respective interests in the venture).

Practitioner Note—Community Property.

Rev. Proc. 2002-69, 2002-2 C.B. 831 gave similar treatment to spouses who are the only owners of an unincorporated entity and they own their interests in the entity as community property. It allows them to treat the entity as a partnership or a disregarded entity. There are no requirements for making an election, but changing from one to the other is treated as a conversion of the entity.

Observation—Differences Between I.R.C. § 761(f) and Rev. Proc. 2002-69.

One difference between I.R.C. § 761(f) and Rev. Proc. 2002-69 is that I.R.C. § 761(f) requires both spouses to materially participate in the venture. Rev. Proc. 2002-69 applies whether one or both of the spouses materially participate.

Another difference between I.R.C. § 761(f) and Rev. Proc. 2002-69 is that I.R.C. § 761(f) allocates the entity income between the spouses for purposes of the self-employment tax according to the spouse's interests in the entity. Under Rev. Proc. 2002-69, the entity is a disregarded entity and the income is allocated between the spouses under I.R.C. § 1402(a)(5)(A). For self-employment tax purposes, that section disregards the community property laws. It allocates all of the income to the spouse carrying on the trade or business, or if the business is jointly operated, it allocates the income on the basis of their distributive share of gross income and deductions.

Expensing for Small Business

Act § 8212; I.R.C. § 179

Effective for tax years beginning after 2006 and before 2011

Background

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment in qualifying property may elect to deduct some or all of its cost under I.R.C. § 179. In general, qualifying property is depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Off-the-shelf computer software placed in service in tax years beginning before 2010 is qualifying property.

The statutory limit on the amount a taxpayer may expense per year for tax years beginning in 2003 through 2009 is $100,000, as adjusted annually for inflation. This limit is reduced if more than $400,000 (as adjusted for inflation) of qualifying property is placed in service during the tax year. For tax years beginning in 2007, the inflation-adjusted amounts were announced to be $112,000 and $450,000, respectively.

The expense deduction may not exceed the year's taxable income derived from the active conduct of a trade or business (determined without regard to the § 179 deduction). Any amount not allowed as a deduction because of the taxable income limitation is carried forward to succeeding tax years.

The $100,000 and $400,000 amounts were scheduled to return to pre-2003 levels of $25,000 and $200,000 for tax years beginning in 2010.

Explanation of Changes

The $100,000 and $400,000 amounts are increased to $125,000 and $500,000, respectively, for tax years beginning in 2007 through 2010. Both amounts will be indexed for inflation in tax years beginning after 2007 and before 2011. In addition, all other I.R.C. § 179 rules that were to expire after 2009 continue in effect for tax years beginning in 2010. This includes the right to revoke or make an expensing election without IRS consent, and the eligibility to expense the cost of off-the-shelf computer software.

Subchapter S Provisions

In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders. The shareholders separately take into account their shares of these items on their individual income tax returns. To prevent double taxation of these items when the stock is later disposed of, the shareholder's basis in his or her S corporation stock is increased by amounts included in income (including tax-exempt income) and is decreased by the amount of losses (including nondeductible losses). A shareholder's loss may be deducted only to the extent of his or her basis in the stock or debt of the S corporation. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward with respect to the shareholder.

Passive Investment Income

Act § 8231; I.R.C. § 1362
Effective for tax years beginning after May 25, 2007

Background
Passive investment income is gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (to the extent of gains). It does not include interest on accounts receivable, gross receipts derived directly from the active and regular conduct of a lending or finance business, gross receipts from certain liquidations, gain or loss from an options or commodities dealer’s I.R.C. § 1256 contracts (or related property), or certain interest and dividend income of banks and depository institution of holding companies.

An S corporation that has accumulated earnings and profits (AE&P) at the close of the tax year is subject to a corporate-level tax at the highest corporate tax rate on its excess net passive income. The corporation has excess passive income if more than 25% of its gross receipts arise from passive investment income. Net passive income is passive investment income reduced by the allowable deductions that are directly connected with the production of that income. To calculate excess net passive income, the corporation’s net passive income for the tax year is multiplied by a fraction: The numerator is the corporation’s passive investment income in excess of 25% of gross receipts and the denominator is the corporation’s total passive investment income for the year.

An S corporation election is terminated if the S corporation has AE&P at the close of each of 3 consecutive tax years and more than 25% of its gross receipts for each of those years is passive investment income.

Explanation of Change
Gains from sales or exchanges of stock or securities are no longer included as an item of passive investment income for tax years beginning after enactment. The gains, rather than the entire proceeds from sales or exchanges of stock or securities, are included in the calculation of the corporation’s gross receipts.

Pre-1983 Earnings and Profits

Act § 8235; no change to I.R.C.
Effective for tax years beginning after May 25, 2007

Background
The Small Business Jobs Protection Act of 1996 eliminated any S corporation earnings and profits (E&P) that accumulated before 1983 for corporations that were S corporations for their tax year beginning in 1997.

Explanation of Change

The elimination of pre-1983 S corporation E&P is extended to all corporations that accumulated E&P in tax years beginning before January 1, 1983, while they were electing small business corporations under Subchapter S of the Internal Revenue Code. E&P accumulated in C corporation years is not affected by the change.

Sale of QSub Interest

Act § 8234; I.R.C. § 1361

Effective for tax years beginning after 2006

Background

An S corporation that owns all the stock of another corporation may elect to treat the subsidiary as a Qualified Subchapter S Subsidiary (QSub). A QSub is disregarded as a separate entity for federal tax purposes, and its items of income, deduction, loss, and credit are treated as items of the S corporation.

If the subsidiary corporation ceases to be wholly owned by the parent, the subsidiary is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) from the parent in exchange for its stock. This exchange is deemed to occur immediately before the cessation.

Under Treasury regulations, the tax treatment of a QSub election termination is determined under general principles of tax law, including the step transaction doctrine. The regulations include an example in which an S corporation sells 21% of its QSub stock to an unrelated party. Because the S corporation has only 79% ownership and is not in control of the QSub immediately after the transfer, the transfer did not qualify for nonrecognition treatment under I.R.C. § 351. Thus, the deemed transfer of assets to the QSub is taxed as a sale.

Explanation of Change

When the sale of QSub stock results in termination of a QSub election, the sale will be treated as a sale of an undivided interest in the assets of the QSub, followed by a deemed transfer to the QSub in a transaction to which I.R.C. § 351 applies.

In the prior example, the S corporation will be treated as selling a 21% interest in all the assets of the QSub to the unrelated party, followed by a transfer of all the assets to a new corporation in a transaction to which I.R.C. § 351 applies. Thus, the S corporation will recognize only 21% of the gain or loss in the assets of the QSub.

The Joint Committee on Taxation report states that the new provision is not intended to change the present-law treatment of the disposition of QSub stock by an S corporation in connection with an otherwise nontaxable transaction. For example, the transfer of QSub stock by an S corporation pro rata to its shareholders can qualify as a distribution to which I.R.C. §§ 368(a)(1)(D) and 355 apply if the transaction otherwise satisfies the requirements of those sections.

Revenue Provisions

Tax on Child's Unearned Income

Act § 8241; I.R.C. § 1(g)

Effective for tax years beginning after May 25, 2007

Background

Special rules (generally called the kiddie tax) apply to the net unearned income of certain children. The kiddie tax applies if all of the following criteria are met:

1. The child is under age 18 at the close of the taxable year

2. Either of the child's parents is alive at that time

3. The child's unearned income exceeds $1,700 (for 2007)

4. The child does not file a joint return

The tax applies regardless of whether the child may be claimed as a dependent by either or both parents.

The kiddie tax subjects the net unearned income of a child above a specified threshold to taxation at the parent's tax rates if the parent's tax rates are higher than the child's tax rates. The child's other taxable income (earned income, plus unearned income up to the threshold, less the child's standard deduction) is taxed at the child's rates, regardless of whether the kiddie tax applies. Unearned income is income other than wages, salaries, professional fees, other amounts received as compensation for personal services actually rendered, and distributions from qualified disability trusts. A child is eligible to use the preferential tax rates for his or her qualified dividends and capital gains.

The allocable parental tax imposed on the child's income equals the hypothetical increase in tax to the parent that results from adding the child's net unearned income to the parent's taxable income. If the child has net capital gains or qualified dividends, these items are allocated to the parent's hypothetical taxable income according to the ratio of net unearned income to the child's total unearned income. If a parent has more than one child subject to the kiddie tax, the net unearned income of all children is combined, and a single kiddie tax is calculated. Each child is then allocated a proportionate share of the hypothetical increase, based on the child's net unearned income relative to the aggregate net unearned income of all of the parent's children subject to the tax.

Explanation of Change

The kiddie tax is expanded to include children who are age 18 or who are full-time students ages 19 through 23 if their earned income does not exceed half of the amount of their support. The tax continues to apply to the unearned income of children under age 18 regardless of their earned income.

Support is calculated under the rules applicable to dependency exemption deductions. Earned income is defined under the rules for the foreign earned income exclusion.

The change is expected to increase revenue by $1,432,000,000 over 10 years.

Return Preparer Penalty

Act § 8246; I.R.C. §§ 6060, 6013, 6107, 6109, 6694, 6695, 6696, 7407, 7427, and 7701
Effective for tax returns prepared after May 25, 2007

Background

An income tax return preparer is any person who prepares for compensation, or who employs other people to prepare for compensation, all or a substantial portion of an income tax return or claim for refund. The definition of an income tax return preparer does not include a person preparing non-income tax returns, such as estate and gift, excise, or employment tax returns.

An income tax return preparer is liable for a first-tier penalty of $250 for preparing a return with an understatement of tax due to an undisclosed position for which there was not **a realistic possibility of being sustained on its merits**, or which is a **frivolous** position, if the preparer knew or reasonably should have known of the position. An income tax return preparer who engages in specified willful or reckless conduct with respect to preparing an income tax return is liable for a second-tier penalty of $1,000.

Explanation of Changes

The scope of the tax return preparer penalties is broadened to include preparers of estate and gift tax, employment tax, and excise tax returns, and returns of exempt organizations. The standards of conduct that must be met to avoid imposition of the penalties also are altered.

- First, the realistic possibility standard for undisclosed positions is replaced with a requirement that there be a r**easonable belief that the tax treatment of the position is more likely than not** the proper treatment.
- The not-frivolous standard accompanied by disclosure is replaced with the requirement that there be a **reasonable basis** for the tax treatment of the position accompanied by disclosure.

The **first-tier penalty** is increased from $250 to the **greater of $1,000 or 50% of the income derived** (or to be derived) by the tax return preparer from preparing the return or claim.

The **second-tier penalty** is increased from $1,000 to the **greater of $5,000 or 50% of the income derived** (or to be derived) by the tax return preparer from preparing the return or claim.

Erroneous Refund Claim

Act § 8247; new I.R.C. § 6676

Effective for claims for refund or credit filed after the date of enactment

Background

Accuracy-related penalties are imposed on a taxpayer in cases involving a substantial valuation misstatement or gross valuation misstatement relating to an underpayment of income tax. A substantial valuation misstatement generally means a value claimed that is at least 200% of the amount determined to be the correct value. A gross valuation misstatement generally means a value claimed that is at least 400% of the amount determined to be the correct value.

The accuracy-related penalty is 20% of the underpayment of tax resulting from a substantial valuation misstatement and 40% of the underpayment resulting from a gross valuation misstatement. No penalty is imposed unless the underpayment attributable to the valuation misstatement exceeds $5,000 ($10,000 for a corporation other than an S corporation or a personal holding company).

No penalty is imposed if the treatment of the item on the return is or was supported by substantial authority, or if facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return **and** there is a reasonable basis for the tax treatment. Special rules apply to tax shelters.

Explanation of Changes

A penalty is imposed on any taxpayer filing an erroneous claim for refund or credit if there is no reasonable basis for the claimed tax treatment. The penalty is 20% of the portion of the claim for which there is no reasonable basis. The penalty does not apply to disallowed earned income credit or to any portion of the claim that is subject to accuracy-related or fraud penalties.

Suspension of Interest

Act § 8242; I.R.C. § 6404(g)

Effective for IRS notices issued after November 25, 2007 (6 months after May 25, 2007)

Background

Interest and penalties accrue during periods for which taxes are unpaid without regard to whether the taxpayer is aware that there is tax due. The Code suspends the accrual of certain penalties and interest starting 18 months after an individual’s tax return is timely filed if the IRS has not sent the taxpayer a notice specifically stating the taxpayer’s liability and the basis for the liability within the specified period. A return filed before the due date is considered to be filed on the due date. Interest and penalties resume 21 days after the IRS sends the required notice to the taxpayer.

The provision applies separately to each item or adjustment, and it does not apply where a taxpayer has self-assessed the tax. In addition, the suspension does not apply to the failure-to-pay penalty, in the case of fraud, or with respect to criminal penalties. It generally does not apply to interest accruing on underpayments resulting from listed transactions or undisclosed reportable transactions.

Explanation of Change

The IRS now has 36 months to send a notice of liability before the suspension period begins. The accrual of applicable penalties and interest is suspended starting 36 months after the tax return is filed if the IRS has not sent the taxpayer a notice specifically stating the taxpayer's liability and the basis for the liability.

Bad Check Penalty

Act § 8245; I.R.C. § 6657

Effective for receipts after May 25, 2007

Background

The penalty imposed on a person who tenders a bad check or money orders is generally 2% of the amount of the bad check or money order. The minimum penalty is $15 (or the amount of the check or money order, if less) for checks or money orders that are less than $750.

Explanation of Change

The minimum penalty is increased to $25 (or the amount of the check or money order, if less) for checks or money orders that are less than $1,250.

Employment Tax Levies

Act § 8243; I.R.C. § 6330

Effective for levies issued on or after September 22, 2007 (120 days after May 25, 2007)

Background

Levy is the IRS's administrative authority to seize a taxpayer's property to pay the taxpayer's tax liability. The IRS is entitled to seize property by levy if a federal tax lien has attached to the property. A federal tax lien arises automatically when all three of the following conditions are met:

1. A tax assessment has been made

2. The taxpayer has been given notice of the assessment, stating the amount and demanding payment, and

3. The taxpayer has failed to pay the amount assessed within 10 days after the notice and demand.

In general, the IRS is required to notify taxpayers that they have a right to a fair and impartial collection due process (CDP) hearing before levy may be made on any property or right to property. Similar rules apply with respect to notices of tax liens, although the right to a hearing arises only on the filing of a notice. The CDP hearing is held by the IRS Office of Appeals, which then issues a determination on the issues raised by the taxpayer. The taxpayer is entitled to appeal that determination to a court.

Taxpayers are not entitled to a pre-levy CDP hearing if a levy is issued to collect a federal tax liability from a state tax refund or if collection of the federal tax is in jeopardy. However, levies related to state tax refunds or jeopardy determinations are subject to post-levy review through the CDP hearing process.

Employment taxes are the taxes imposed under the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA), plus the income taxes that employers are required to withhold from wages paid to employees.

Explanation of Changes

A levy issued to collect federal employment taxes is excepted from the pre-levy CDP hearing requirement if the taxpayer subject to the levy requested a CDP hearing with respect to unpaid employment taxes arising in the 2-year period before the beginning of the tax period for which the employment tax levy is served. The taxpayer may request a hearing within a reasonable period of time after the levy, but collection by levy of employment tax liabilities is permitted to continue during CDP proceedings.

Permanent Extension of User Fees

Act § 8244; I.R.C. § 7528
Effective for requests made after May 25, 2007

Background
The IRS charges a user fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination. These fees are authorized by statute through September 30, 2014.

Explanation of Change
The statutory authorization for IRS user fees is permanently extended.

TAX RELIEF AND HEALTH CARE ACT OF 2006

Legislation making more than 200 changes to the Internal Revenue Code became Public Law 109-432 on December 20, 2006. This update summarizes its major tax provisions that affect farmers in 2007 and later years.

New Provisions

Act §§209, 210, 404, 405, 408, 417, 418, 419, 402, 403; I.R.C. §§45N, 53, 121, 163, 168, 179E, 1043, 4132, 6039, 9508
Several time-limited provisions add new tax benefits for selected taxpayers.

Mortgage Insurance Premium Deduction

The cost of mortgage insurance on a qualified personal residence will be treated as qualified residence interest for 2007 only. The deduction is phased out by 10% for each $1,000 by which the taxpayer's AGI exceeds $100,000 ($500 and $50,000, respectively, for a married individual filing a separate return). Thus, the deduction is not allowed if the taxpayer's AGI exceeds $110,000 ($55,000 for a married individual filing a separate return).

Qualified mortgage insurance means mortgage insurance provided by the Veterans Administration, the Federal Housing Administration, or the Rural Housing Administration, as well as private mortgage insurance (defined in section 2 of the Homeowners Protection Act of 1998, as in effect on December 20, 2006). Amounts that are properly allocable to periods after the close of the tax year are treated as paid in the period to which they are allocated. No deduction is allowed for the unamortized balance if the mortgage is paid before its term, except in the case of qualified mortgage insurance provided by the Department of Veterans Affairs or Rural Housing Administration.

The provision does not apply with respect to a mortgage insurance contract issued before January 1, 2007. It is effective for amounts paid or accrued (and applicable to the period) after December 31, 2006, and before January 1, 2008, for mortgage contracts issued after December 31, 2006.

Alternative Minimum Tax Credit

A new refundable credit beginning in 2007 is based on prior year minimum tax liability. Taxpayers who have been unable to use nonrefundable alternative minimum tax (AMT) credits by the fourth year after the AMT credit year may claim a refundable credit for the next 5 years. The provision is effective for taxable years beginning after December 20, 2006, and it sunsets on December 31, 2012.

The AMT refundable credit amount is the greater of:

1. $5,000 (or the long-term unused minimum tax credit, if less) or
2. 20% of the long-term unused minimum tax credit.

The long-term unused minimum tax credit is the portion of the minimum tax credit attributable to the adjusted net minimum tax for taxable years before the third taxable year immediately preceding the taxable year, assuming the credits are used on a first-in, first-out basis.

The refundable credit phases out for taxpayers with AGI exceeding the threshold amount for phase-outs of personal and dependency exemption deductions. The refundable credit amount then is reduced by the applicable percentage for the reduction of the exemption deductions.

Example 1. AMT Refundable Credit

Alan Rensch has a regular tax of $45,000, a tentative minimum tax of $40,000, no other credits or payments, and a minimum tax credit for the taxable year of $1.1 million, of which $1 million is a long-term unused minimum tax credit. In addition, Alan's AGI results in a 50% reduction of his exemption deductions. His nonrefundable minimum tax credit for the tax year is limited to the $5,000 excess of his regular tax over his tentative minimum tax.

Alan's maximum AMT refundable credit amount for the tax year is $100,000 (20% of the $1 million long-term unused minimum tax credit, reduced by an applicable percentage of 50%). The minimum tax credit allowable for the taxable year is also $100,000 (the greater of the AMT refundable credit amount or the amount of the credit otherwise allowable).

The $5,000 credit allowable without regard to the new law is nonrefundable, but the additional $95,000 of credit is treated as a refundable credit. Thus, Alan has an overpayment of $55,000 ($45,000 regular tax less $5,000 nonrefundable AMT credit less $95,000 refundable AMT credit) that is allowed as a refund or credit. The remaining $1 million minimum tax credit is carried forward to future taxable years.

If Alan's AGI did not exceed the threshold amount for reduction of exemption deductions, his AMT refundable credit amount for the tax year would be $200,000, and his overpayment would be $155,000.

Observation—Incentive Stock Option Impetus.

Although AMT liability arising from exercise of incentive stock options is cited in the committee reports as the rationale for the refundable credit, the provision is not limited only to AMT paid for this reason.

Health Savings Accounts

Act §§117, 301-307; I.R.C. §220, 223

Contribution Limits

The limitation on health savings account (HSA) contributions based on the annual deductible for the taxpayer's health insurance plan is repealed for years beginning in 2007 and later. The TRHCA will allow a contribution of $2,850 for single coverage ($5,650 for family coverage), even if the insurance deductible is less than $2,850 ($5,650 family).

Enrollment in employer-provided health plans usually takes place in November or early December, but in prior years the adjustments to HSA limits were not released until late in the year, making preparation of enrollment materials and advance planning difficult. The new law requires indexing of limits by June 1, using the Consumer Price Index for a 12-month period ending March 31, for taxable years beginning after 2007.

Planning Pointer—2008 Contribution Limits.

For calendar year 2008, the limitation on deductions for an individual with self-only coverage under a high deductible health plan is $2,900, and the limitation on deductions for family coverage is $5,800 (Rev. Proc. 2007-36, 2007-22 IRB 1335).

In addition, under prior law, the HSA contribution limit was prorated if the taxpayer was covered by a high-deductible health plan for less than 12 months. However, the minimum deductible was not prorated. Effective for 2007, the TRHCA allows a full year's contribution to be made to an HSA for a partial year's coverage if the taxpayer maintains the high-deductible plan for the following coverage year. Failure to maintain the high-deductible coverage for the entire testing period results in a loss of the deduction for the months preceding the month the individual became eligible. A 10% penalty also applies, unless the employee ceases to be an eligible individual by reason of death or disability. The testing period is the period beginning with the last month of the taxable year and ending on the last day of the twelfth month following that month.

Example 2. Health Savings Account

Barb Weyer enrolls in a high-deductible plan in December 2007 and is otherwise an eligible individual in that month. She was not an eligible individual in any other month in 2007. Barb may make HSA contributions as if she had been enrolled in the high-deductible plan for all of 2007. If she ceases to be covered under a high-deductible health plan in June 2008, an amount equal to the HSA deduction attributable to treating her as an eligible individual for January through November 2007 is included in her income in 2008. In addition, a 10% additional tax applies to the amount includable.

A fourth change to the HSA contribution rules applies to employers. Under prior law, employers that contribute to HSAs on behalf of employees must make comparable contributions for all employees. The TRHCA allows employers to provide additional contributions to lower-paid workers, effective for taxable years beginning after December 31, 2006.

Transfers from Other Accounts

Direct Transfer from IRA

Beginning in 2007, a one-time contribution may be made to an HSA through a direct trustee-to-trustee transfer from an individual retirement arrangement (IRA). The IRA transfer is not includable in income and is not subject to the 10% additional tax on early distributions. However, no deduction is allowed for the amount contributed from an IRA to an HSA.

The amount that can be transferred is limited to the otherwise deductible HSA contribution computed on the basis of the type of coverage under the high-deductible health plan at the time of the contribution. The transfer reduces the amount that can otherwise be contributed to the HSA for the year of the contribution.

Only one transfer may be made during the lifetime of the individual, except that if the transfer is made during a month in which an individual has self-only coverage as of the first day of the month, an additional transfer may be made during a subsequent month within the same tax year when the individual has family coverage.

If the individual does not remain an eligible individual during a testing period, the transfer is includable in gross income of the individual. An exception applies if the employee ceases to be an eligible individual by reason of death or disability. The testing period is the period beginning with the month of the contribution and ending on the last day of the twelfth month following that month. A 10% additional tax also applies to the amount includable.

The provision does not apply to simplified employee pensions (SEPs) or to SIMPLE retirement accounts, but it does apply to Roth IRAs.

Other Health Account Termination

An employer can make a one-time transfer of the balance in an employee's health reimbursement account (HRA) or health flexible spending account (FSA) to an HSA. The maximum transfer is the lesser of the HRA/FSA balance on the date of transfer or on September 21, 2006. The balance in the health FSA or HRA is determined on a cash basis, so that expenses incurred that have not been reimbursed as of the date the determination is made are not taken into account. Transfers must be made before January 1, 2012.

The transferred amounts are excludable from gross income and from wages for employment tax purposes, are not taken into account in applying the maximum deduction limitation for other HSA contributions, and are not deductible. If a high-deductible plan is not maintained for at least 12 months following the transfer, the transferred amount is taxable as ordinary income and subject to a 10% excise tax. An exception applies if the employee ceases to be an eligible individual by reason of death or disability.

The IRS has provided guidance on these transfers in Notice 2007-22, 2007-10 IRB 670.

Disregarded Coverage

The TRHCA does not modify the FSA grace period that allows any FSA balance remaining at the end of a year to be used up in the first 2½ months of the following year if the plan allows the grace period. The Treasury Department has concluded that participation in an FSA that permits use of a balance for 1 year in the following year precludes contributions to an HSA for the first 2½ months of the following year.

However, for taxable years beginning after December 31, 2006, coverage under a health FSA during the grace period can be disregarded coverage if either of the following applies:

1. The balance in the health FSA at the end of the plan year is zero, or
2. The entire remaining balance in the health FSA at the end of the plan year is transferred to an HSA.

Archer Medical Savings Accounts

After 2005, no new contributions could be made to Archer Medical Savings Accounts (MSAs) except by or on behalf of individuals who previously made (or had made on their behalf) Archer MSA contributions and employees who are employed by a participating employer. The TRHCA allows new contributions through December 31, 2007.

PENSION PROTECTION ACT OF 2006 (PPA)

Public Law 109-280, enacted August 17, 2006, makes several provisions of 2001 legislation permanent, tweaks 401(k) plans, and changes funding standards and deduction limits for traditional pension plans. It's not entirely a pension bill, however—it also tightens rules for deducting charitable donations. Several provisions are effective for all or part of the 2006 tax year.

Conservation Easements

Act §1206; I.R.C. §170

Effective for contributions made in 2006 and 2007

Background

Qualified conservation contributions are not subject to the rule that generally bars deductions for charitable contributions of partial interests in property. A qualified conservation contribution is a contribution of a *qualified real property interest* to a qualified organization exclusively for conservation purposes. A qualified real property interest is either the entire interest of the donor other than a qualified mineral interest; a remainder interest; or a restriction granted in perpetuity on the use that may be made of the real property.

Conservation purposes include the following:

- Preservation of land areas for outdoor recreation by (or for the education of) the general public
- Protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem
- Preservation of open space (including farmland and forest land) that will **yield a significant public benefit** and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated governmental conservation policy
- Preservation of a historically important land area or a certified historic structure.

The value of a conservation easement is determined using a **before and after approach**—the FMV of the restriction is equal to the difference (if any) between the property's FMV before the restriction is granted and its FMV after the restriction is granted. If the restriction increases the value of any other property owned by the donor or a related person, the charitable deduction is reduced by the increase in value of the other property. In addition, the donor must reduce the amount of the charitable deduction by the economic benefits that the donor or a related person can reasonably be expected to receive as a result of the contribution. If those benefits are greater than the benefits that will inure to the general public from the transfer, no deduction is allowed.

If capital gain property is donated to a qualifying 50% organization, and the taxpayer deducts the FMV of the contribution, the current-year deduction may not exceed 30% of the taxpayer's contribution base (generally, adjusted gross income). Excess amounts may be carried forward for up to 5 years.

Explanation of Change

The PPA changes the Schedule A (Form 1040) **deduction limit** for qualified conservation contributions to **50% of the contribution base** minus all other allowable charitable contributions for the tax year. Qualified conservation contributions that exceed the current year deduction limitation may be **carried over for up to 15 years**.

Qualified farmers or ranchers filing Form 1040 may deduct a qualified conservation contribution up to **100% of the contribution base** minus all other allowable charitable contributions. If the qualified farmer or rancher is a corporation, a qualified conservation contribution is allowable up to 100% of the excess of the corporation's taxable income computed under I.R.C. §170(b)(2) over the amount of all other allowable charitable contributions. The 100% limitation also applies to carryforwards for qualified farmers and ranchers. To be a qualified farmer or rancher, more than 50% of the taxpayer's gross income for the year must come from the trade of business of farming, within the meaning of I.R.C. §2032A(e)(5).

An additional condition of eligibility for the 100% limitation for contributions of property that is available for or used in agriculture or livestock production is that the donated interest must include a restriction that the property remain generally available for such production.

Example XX.1 Farm Conservation Easement

Belle Vista, who has a 2006 contribution base (AGI) of $100,000, donated a conservation easement with a $60,000 FMV and made $15,000 of other charitable contributions subject to the 50% limit. Because her total deduction is limited to $50,000 (50% of $100,000), Belle can deduct all $15,000 of the other contributions but only $35,000 of the conservation easement donation on her 2006 return. She can carry the remaining $25,000 forward for up to 15 years. If Belle were a qualified farmer or rancher, she could deduct the entire $60,000 as well as the $15,000 in other contributions.

TAX INCREASE PREVENTION AND RECONCILIATION ACT OF 2005 (TIPRA)

Public Law 109-222 was enacted May 17, 2006, but, as a carryover from 2005 budget reconciliation measures, it has a 2005 designation.

Capital Gains and Dividends

Act §102; I.R.C. §1(h)

Effective for tax years beginning in 2009 and 2010

Background

For tax years beginning before January 1, 2009, the maximum rate of tax on the adjusted net capital gain of an individual is 15%. Adjusted net capital gain that otherwise would be taxed at a 10% or a 15% rate is taxed at a 5% percent rate (zero for tax years beginning in 2008). These rates apply for purposes of both the regular tax and the alternative minimum tax. An individual's unrecaptured I.R.C. §1250 gain is taxed at a maximum rate of 25% and the individual's 28% rate gain is taxed at a maximum rate of 28%. Any amount of unrecaptured §1250 gain or 28% rate gain that otherwise would be taxed at a 10% or 15% rate is taxed at the otherwise applicable rate.

- *Net capital gain* is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.
- The *adjusted net capital gain* of an individual is the net capital gain reduced (but not below zero) by the sum of the 28% rate gain and the unrecaptured I.R.C. §§1250 gain. Net capital gain is also reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under I.R.C. §163(d).
- The term *28% rate gain* means net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (generally using the definition applicable to individual retirements accounts) and gain equal to gain excluded from gross income under I.R.C. §1202 (relating to certain small business stock), reduced by any net short-term capital loss for the taxable year and any long-term capital loss carryover to the taxable year.
- *Unrecaptured §1250 gain* means any long-term capital gain from the sale or exchange of §1250 property (depreciable real estate) held more than one year, to the extent of the gain that would be treated as ordinary income if I.R.C. §1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28% rate gain. The amount of unrecaptured

§1250 gain (before reduction for a net loss) attributable to the disposition of property to which I.R.C. §1231 (relating to certain property used in a trade or business) applies may not exceed the net section I.R.C. §1231 gain for the year.

Qualifying dividends received by an individual from domestic corporations and certain foreign corporations **are taxed at the same rates that apply to net capital gains**. Thus, for tax years beginning before 2009, dividends received by an individual are taxed at rates of 5% (zero for tax years beginning in 2008) and 15%. This treatment also applies for purposes of both the regular tax and the alternative minimum tax. A qualifying dividend is treated as investment income for determining deductible investment interest only if the taxpayer elects to treat the dividend as not eligible for the reduced tax rates.

Prior Law

For tax years beginning after 2008, the maximum rate of tax on the adjusted net capital gain of an individual is 20%. Adjusted net capital gain that otherwise would be taxed at a 10% or a 15% rate is taxed at a 10% rate. Gain from the sale or exchange of property held more than 5 years that would otherwise have been taxed at the 10% rate is taxed at an 8% rate. Gain from the sale or exchange of property held more than 5 years with a holding period that began after December 31, 2000, is taxed at an 18% rate if it otherwise have been taxed at the 20% rate. The tax rates on 28% gain and unrecaptured §1250 gain are the same as for tax years beginning before 2009.

Dividends received by an individual are to be taxed at ordinary income tax rates for tax years beginning after 2008.

Explanation of Change

The TIPRA extends for 2 years, through tax years beginning on or before December 31, 2010, the 0% and 15% rates on an individual's adjusted net capital gain and qualifying dividends.

Example 3. Capital Gains Tax

Rich Tyree plans to stop farming at age 64 in 2008. He will delay drawing social security benefits or his pension until he is age 67, and he expects to have very little taxable income in the intervening years. However, his farm has appreciated in value over the years. During the years 2008, 2009, and 2010, Rich will pay no tax on the capital gains he realizes from selling his farm, as long as he keeps his total taxable income within the 15% tax bracket. If his income creeps into the 25% bracket, he will pay a 15% tax on the capital gain to the extent that his income exceeds the 15% bracket.

SELF-EMPLOYMENT TAX AND SOCIAL SECURITY BENEFITS

Issue 1. Self-Employment Tax on Land Rented to an Entity

The on-going saga of whether the rental payment for farmland paid to a landowner who is materially participating in the farm operation is subject to self-employment tax continues. In October 2003, the IRS entered a non-acquiescence in the appellate court decision of McNamara v. Commissioner, 236 F.3d 410 (8th Cir.2000), rev'g T.C. Memo. 1999-333, non-acq.,I.R.B. 2003-42. More recently, the Tax Court reached different results in Solvie v. Commissioner, T.C. Memo. 2004-55 and Johnson v. Commissioner, T.C. Memo. 2004-56 because the shareholder/employees' obligations under the lease were different.

Background

I.R.C. §1401 imposes a tax on the self-employment income of every individual. I.R.C. §1402(a) defines net earnings from self-employment as the gross income derived by an individual from any trade or business carried on by the individual less allowable deductions attributable to such trade or business. Generally, rentals from real estate or personal property rented with real estate are excluded from the computation of net earnings from self-employment. In the so-called exception to the exception, I.R.C. §1402(a)(1) provides that rentals received by the owner of land are included as earnings for self-employment if:

1. The income is derived under an arrangement, between the owner and the tenant, that requires the owner to materially participate in the production or management of the production of agricultural or horticultural commodities , and
2. There is material participation by the owner in the agricultural or horticultural commodities."

Until 1995, IRS did not challenge the common situation in which an individual treated the rent received from an entity for farmland held outside the entity as not being subject to self-employment tax.

Example 1. Land Rented to Corporation

Larry Landowner is the sole shareholder and employee of a corporation that owns farm machinery and equipment. The corporation operates a farming business on land rented from Larry. Larry owns the farmland in his own name and share rents the land to the corporation. Prior to 1995, the IRS did not require Larry to pay self-employment tax on the rent.

IRS Wins

In 1995, the IRS successfully argued the position that rent received by a landowner for land used in farming is subject to self-employment tax if:

1. there is an arrangement calling for the landowner's material participation, and
2. there is material participation by the landowner.

The IRS was successful in *Mizell v. Commissioner*, T.C. Memo 1995-571 (share-rent from partner to partnership); *Bot v. Commissioner*, T.C. Memo 1999-256 (cash rent from wife/employee to husband/employer); *Hennen v. Commissioner*, T.C. Memo 1999-306 (cash rent from shareholder employee to corporation); and *McNamara v. Commissioner*, T.C. Memo 1999-333 (cash rent from shareholder employee to corporation).

Taxpayer Wins

In December of 2000, the 8th Circuit Court of Appeals reversed and remanded the McNamara, Bot and Hennen cases, which were consolidated for the appeal to the 8th Circuit. [McNamara v. Commissioner, 236 F.3d 410 (8th Cir. 2000)]. The 8th Circuit focused on the "nexus" between rent and the employment agreement and held that the lessor-lessee arrangements should stand on their own. The Court took the position that "the mere existence of an arrangement requiring and resulting in material participation…does not automatically transform rents received into self-employment income." Furthermore, rents that are consistent with fair market value rents "very strongly suggest" that the rental arrangement should stand on its own and the rent would not be subject to self-employment tax. The Tax Court entered a decision on July 10, 2002 apparently indicating that no evidence was presented that the rents were not a fair rental value and the taxpayers did not have to pay self-employment tax on the rent.

Practitioner Note—States in 8th Circuit.

The 8th Circuit includes the states of Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota and South Dakota.

Practitioner Note—2nd Circuit Case.

Fowler v. Commissioner, T.C. Docket No. 013920-01, Dec. 14, 2001, a case involving a New York State apple and produce farm was scheduled for trial in September 2003. This case would have been appealable to the 2nd Circuit, but was dismissed with an undisclosed agreement with the IRS.

IRS Position

In Action on Decision 2003-003, October 22, 2003, IRS indicated their disagreement with the 8th Circuit's "narrow" construction of the term "arrangement" in *McNamara*. The IRS continues to assert that it is correct to look at the overall scheme of farming operations in determining whether rentals are derived under an arrangement calling for material participation in farming. If, under the overall scheme of farming operations it was understood that that farmer would materially participate in farm production, and the farmer did in fact materially participate, then the IRS position is that income received as rent is subject to self-employment tax.

Arrangement and Material Participation

Treas. Reg. §1.1402(a)-4(b)(3)(i) indicates that a contractual arrangement may be oral or written, but the scope of the arrangement must require the owner to materially participate with respect to the production or management of the commodities. Furthermore, such participation must be material when considering both production and management. IRS Publication 225, The Farmer's Tax Guide, indicates that a landowner is considered to materially participate if he or she has an arrangement with the tenant for the landowner's participation and the landowner meets one of the following tests:

1. The landowner does any three of the following:
   - Pays, using cash or credit, at least half of the direct costs of producing the crop or livestock.
   - Furnishes at least half the tools, equipment, and livestock used in the production activities.
   - Advises or consults with the tenant.
   - Inspects the production activities periodically.

2. The taxpayer regularly and frequently makes or takes an important role in management decisions substantially contributing to, or affecting the success of, the enterprise.

3. The taxpayer works 100 hours or more spread over a period of five or more weeks in activities connected with agricultural production.

4. Taxpayer does things that, considered in their totality, show the taxpayer is materially and significantly involved in the production of the farm commodities.

Solvie v. Commissioner, T.C. Memo 2004-55

This case involved a husband and wife who owned a family farm corporation in Minnesota. The taxpayers rented land and buildings as well as some personal property to the corporation. The taxpayers constructed an 800-head capacity hog barn and rented it to the corporation for $21 per head per rotation of hogs processed through the building. The Court found that the $21 rent was approximately twice the rents received for similar buildings, and that if no hogs had been processed through the hog barn then no rent would have been paid. Thus, the taxpayers failed to show there was no nexus between the rent received and the oral employment agreement under which the taxpayers were to, and did, materially participate in production. The rent, reduced by the deductions attributable to the rent, was considered net earnings for self-employment tax.

Johnson v. Commissioner, T.C. Memo 2004-56

This case involved similar issues and was heard by the same judge as Solvie. The Johnsons were Minnesota crop farmers whose wholly owned corporation paid rent "for the lease of farmland and personal property, irrespective of whether or not that company had a good farming year or had income." Although the success of their corporation depended on the farm-related activities of the taxpayers, they did not believe that they were, and they were not, obligated or compelled to perform farm-related production activities of the corporation as a condition of the oral rental arrangement of their land. The Court found that the rents claimed were consistent with rents paid to third-party landlords and that there was no nexus between the rent and the oral employment agreement under which the Johnsons materially participated in the production of agricultural commodities. The rents, reduced by the deductions attributable to such respective rents, are not subject to self-employment tax.

Planning Ideas

Taxpayers In the 8th Circuit

The Solvie and Johnson cases, together with AOD 2003-03, begin to provide a firmer basis for tax planning for farm families in the 8th Circuit who are protected by the holding of the McNamara case. Those taxpayers should consider the following points.

1. Rents paid by an entity for more than fair market rental values are likely to be subject to self-employment tax if there is an employment agreement or other arrangement requiring the landowner's material participation and the landowner materially participates in the farming activity. Rental rates that exceed the fair market rental rate suggest that there is a nexus between the rent and the arrangement. Rental rates should be documented and records kept of prior years' rental rates.
2. Rents that depend on the taxpayer's material participation in production are more likely to attract IRS attention. This suggests that cash rents, rather than share leases in which payments depend on the level of production, may be less likely to attract IRS attention. Reasonable cash rents should be paid regardless of the success of the farming entity.
3. If the landowner is paid wages as part of an employment agreement the wages must be reasonable compensation for the taxpayer. Compensation of the taxpayer partially in commodities, perhaps as a bonus, can avoid FICA tax [I.R.C. §3121(a)(8)(A)].
4. It is important to show that there would have been rental income in the absence of the taxpayer's services to the farming entity. A rental agreement that is independent of the taxpayer's employment agreement would be helpful.
5. It is important that past practices show that the services would not have been performed without an employment contract.

Taxpayers Outside the 8th Circuit

For taxpayers outside the 8th Circuit the IRS has stated that it will continue to pursue its argument that rent for land used in agricultural production is subject to self-employment tax if any arrangement (lease, employment agreement, partnership agreement, etc.) requires the landowner to materially participate and the landowner does materially participate. [AOD 2003 003]. However, taxpayers outside the 8th Circuit can argue that the decision of the 8th Circuit in *McNamara* does provide substantial authority for not including rent in their self-employment income.

These taxpayers should consider the following points:

An arrangement in which an individual owns the land and that individual does not materially participate in the farm business should avoid self-employment tax on the rental income.

a. For example, a farmer's spouse who inherits or independently buys farmland, rents it at fair market value to the farming spouse and does not materially participate in the farming business should not be subject to self-employment tax on the rent.
b. If the land is already owned by the farming spouse or by both spouses jointly, the IRS could challenge a transfer of land to the non-farming spouse as having no purpose other than to avoid self-employment tax.
c. If both spouses materially participate in the farming business, they could consider transferring ownership to other family members who do not materially participate in the farm business. The IRS could challenge a transfer of land to the non-farming family members as having no purpose other than to avoid self-employment tax.

Transferring the land to an entity may avoid self-employment tax on the rent.

d. For example, if a corporation owns the land, neither the corporation nor the shareholders will be subject to self-employment tax on the rent paid to the corporation. The advantage of avoiding self-employment tax may be more than offset by disadvantages such as double taxation for C corporations and the loss of a step-up in the land's basis on the death of the shareholders.
e. If the land is owned by an LLC or a limited partnership in which most of the interests are held as limited members or partners, self-employment tax could be limited to the rent that flows through to the general members or partners.
f. If the land is owned by a trust, the beneficiaries are arguably not subject to self-employment tax on the rent even if they materially participate in the farming business.

Practitioner Note—Rent for Buildings.

Rent paid for buildings is not rent for land used in agricultural production. Therefore, it qualifies for the "rent on real estate" exception but is not in the "rent on agricultural land" exception. Consequently, rent on buildings is not subject to SE tax even if the material participation requirements are met.

Issue 2: Conservation Reserve Program (CRP) Payments

In 2003, the IRS indicated how it will apply the self-employment tax rules to Conservation Reserve Program (CRP) payments in CCA 200325002. In Notice 2006-108, 2006-51 IRB 1118 (December 5, 2006) it reiterated its position and announced that it intends to issue a revenue ruling. Notice 2006-108 addresses two hypothetical sets of facts.

First Hypothetical Facts

Farmer A is engaged in the business of farming on land that A owns. Farmer A farms a portion of his cropland and has enrolled the remaining portion of his cropland in the CRP program. Farmer A enters into a 10-year CRP contract with the USDA for the primary purpose of earning a profit from the land. The terms of A's CRP contract require that he will receive payments if he will (1) implement a conservation plan; (2) establish vegetative cover; (3) not engage in or allow grazing, harvesting, or other commercial use of the CRP land; (4) not use the land for agricultural purposes except as permitted by the USDA; (5) not harvest, sell, or otherwise make commercial use of trees on the CRP land; (6) control on the CRP land all weeds, insects, pests, and other undesirable species to ensure the establishment and maintenance of the approved cover; and (7) file annual CRP reports. In order to implement the conservation plan, the terms of the contract require significantly more activities to be performed in the first year of the contract than in the later years. Farmer A personally completes the activities required under the CRP contract for tilling, seeding, fertilizing, and weed control using his own farm equipment. Farmer A also satisfies the other requirements of the contract. In return, he receives CRP rental payments each year during the contract term. Farmer A also receives cost-sharing payments based on the costs he incurs in performing his obligations under the CRP contract.

Second Hypothetical Facts

The facts are the same as in the first hypothetical facits, except that farmer B, who owns the land, ceases all activities related to the business of farming in the year before he enters into the CRP contract. In the next calendar year B rents out a portion of his land to another farmer and enters into a 10-year CRP contract with respect to the remaining portion of his land. Farmer B arranges for a third party to perform the tilling, seeding, fertilizing, and weed control required under the CRP contract and to fulfill the other contractual requirements. In return, B receives CRP rental payments each year during the contract term. He also receives cost-sharing payments based on the costs he incurs in implementing CRP on the land.

Law

I.R.C. §1401 imposes a tax on the self-employment income of every individual (SECA tax). The term *self-employment income* is defined in I.R.C. §1402(b) as the net earnings from self-employment derived by an individual, with certain limitations.

I.R.C. §1402(a) defines an individual's "net earnings from self-employment" as the gross income derived by an individual from any trade or business carried on by such individual, also with certain limitations. I.R.C. §1402(a)(1) generally excludes from the computation of "net earnings from self-employment" 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, with an exception. Under this exception, any income derived by the owner or tenant of land must be included in the computation of "net earnings from self-employment" if

a. Such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other 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

b. 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.

I.R.C. §1402(c) provides that the term *trade or business*, when used with reference to self-employment income or net earnings from self-employment, shall have the same meaning as when used in I.R.C. §162 (relating to trade or business expenses), less allowable deductions.

In considering whether an individual is engaged in a trade or business, the United States Supreme Court has stated that "to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity, and the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity . . . does not qualify" [*Commissioner v. Groetzinger*, 480 U.S. 23 (1987)]. The question of whether a taxpayer is engaged in a trade or business requires an examination of the relevant facts in each case. *Id.* at 36.

In *Wuebker v. Commissioner*, 205 F.3d 897 (6th Cir. 2000), the Sixth Circuit held that CRP payments received by a farmer actively engaged in the business of farming were includable in self-employment income. The court concluded that their "agreement . . . required them to perform several ongoing tasks with respect to the land enrolled in the CRP, the very land they already owned and had previously farmed." The Sixth Circuit noted that the taxpayers were required under the CRP contract to perform tasks intrinsic to the farming trade or business (e.g., tilling, seeding, fertilizing, and weed control) that required the use of their farming equipment (*Id.* at 903). In addition, under the court's view, the CRP payments were not payments of rent for the use or occupancy of property and therefore were not rentals from real estate excluded from SECA by I.R.C. §1402(a)(1). The court observed that the essence of the CRP program is to prevent participants from farming enrolled property and to require the participants to perform various activities in connection with the land continuously throughout the life of the contract with the government's access limited to inspections (*Id.* at 904). Furthermore, the Sixth Circuit looked to the "substance, rather than the form, of the transaction" in determining that the income derived from the CRP contract is includable in self-employment income earned in lieu of farm income, for which SECA tax was due.

Under I.R.C. §126(a), gross income does not include the excludable portion of payments received under certain conservation programs. Revenue Ruling 2003-59, 2003-1 C.B. 1014, holds that all or a portion of cost-sharing payments received under the CRP are eligible for the exclusion from gross income permitted by I.R.C. §126. The ruling also holds that rental payments and incentive payments received under the CRP are not cost-sharing payments and therefore are not excludable from gross income.

Analysis

Under *Groetzinger* an activity will be a trade or business if the taxpayer "is involved in the activity with continuity and regularity and . . . the taxpayer's primary purpose for engaging in the activity must be for income or profit." Participation in a CRP contract is a trade or business for both farmers A and B. The participant is obligated to perform a number of activities, including but not limited to tilling, seeding, fertilizing, and weed control. Although more extensive activities are required at the beginning of the contract term than later, the obligation to perform activities extends throughout the 10-year period, giving participation in CRP the continuity and regularity necessary to be considered a trade or business. Also, both A and B enrolled land in the CRP program to earn a profit. Participation in a CRP contract meets the criteria to be a trade or business irrespective of whether the participant performs the required activities personally or arranges for his obligations to be satisfied by a third party. Thus, the trade or business treatment is the same for A and B even though A meets the CRP requirements for maintenance of the land himself whereas B arranges for someone else to do it. Furthermore, the CRP meets the criteria to be a trade or business based on the activities required directly under the program and without being affected by whether the participant is otherwise engaged in farming or any other trade or business. Finally, although 16 U.S.C. §3801(a)(13) refers to some of these payments as rent, the treatment of these payments under the Internal Revenue Code depends upon their substance. CRP rental payments are not payments for the right to use or occupy real property. CRP rental payments are made in exchange for conducting activities that meet the commitments of a CRP contract. Therefore, CRP rental payments are not excluded from net income from self-employment under I.R.C. §1402(a)(1) as rentals from real estate. See *Wuebker*, supra. Thus, for both A and B, the CRP rental payments are includable in their net income from self-employment.

To the extent that a cost-sharing payment is excluded from gross income under I.R.C. §126, that portion of the payment would also be excluded from the gross income derived by an individual from the trade or business carried on by the individual. Consequently, to the extent such payment is excluded from gross income under I.R.C. §126, the payment is also excluded from net earnings from self-employment.

Holding

CRP rental payments (including incentive payments) from the USDA to (1) a farmer actively engaged in the trade or business of farming who enrolls land in CRP and fulfills the CRP contractual obligations personally and (2) an individual not otherwise actively engaged in the trade or business of farming who enrolls land in CRP and fulfills the CRP contractual obligations by arranging for a third party to perform the required activities are both includable in net income from self-employment for purposes of the SECA tax and not excluded from net income from self-employment as rentals from real estate.

[Notice 2006-108, 2006-51 IRB 1118]

WEATHER-RELATED SALES OF LIVESTOCK

Livestock producers who are forced to sell animals because of weather-related conditions, such as flood, drought, or other conditions that cause a shortage of water or feed, may be eligible to postpone recognition of income from the proceeds and avoid bunching of income.

The two different tax treatments apply only to weather-related sales of livestock in excess of normal business practices. The first applies to draft, breeding, or dairy animals that will be replaced within a 2-year period. The second applies to all livestock and allows a 1-year postponement of reporting the sales proceeds as taxable income.

Involuntary Conversion [I.R.C. §1033(e)]

The sale or exchange of livestock (other than poultry) held for draft, breeding, or dairy purposes in excess of the number sold as usual or normal business practice is treated as an involuntary conversion if the livestock are sold or exchanged solely on account of drought, flood, or other weather-related conditions, I.R.C. §1033(e).

If livestock (other than poultry) **held for any length of time** for draft, breeding, or dairy purposes is sold because of weather related conditions, the gain realized on the sale does not have to be recognized, if the proceeds are used to purchase replacement livestock within 2 years from the end of the tax year in which the sale takes place. The 2-year replacement period is extended to 4 years if weather condition that caused the sale also caused an area to eligible for assistance by the federal government and can be further extended by the Secretary of Treasury if the weather condition continues for more than 3 years [I.R.C. §1033(e)(2)].

Practitioner Note—No Required Holding Period

There is no required holding period for this provision as there is in I.R.C. §1231.

Generally, the new livestock purchased must be used for the same purpose as those sold because of weather-related conditions. Breeding stock must be replaced with breeding stock, and dairy cows with dairy cows. However, if the condition that caused the involuntary conversion also makes it infeasible to replace the livestock with similar livestock, then the livestock can be replaced with any property, including real property, used in the farming business [I.R.C. §1033(f)].

The taxpayer must show the weather-related condition caused the sale of more livestock than would normally have been sold. Only the additional animals sold in excess of normal sales can be replaced without recognition of gain. If the taxpayer normally sells one-fifth of the herd each year, only the sales in excess of one-fifth will qualify for deferral. There is no requirement that the weather-related conditions cause an area to be declared a disaster area by the federal government. The taxpayer will have basis in the replacement livestock equal to the basis in the livestock sold, plus any amount invested in the replacement livestock that exceeds the proceeds from the sale.

Election

The election to defer recognition of gain is made by attaching a statement to the tax return that includes the following information:

- Evidence of the weather-related conditions that forced the sale or exchange of the livestock
- A computation of the amount of gain realized on the sale or exchange
- The number and kind of livestock sold or exchanged
- The number of livestock of each kind that would have been sold or exchanged under usual business practices of the taxpayer

Deferral of Income for 1 Year [I.R.C. §451(e)]

Cash-method farmers can elect to defer for 1 tax year the reporting of income from certain livestock sold on account of drought, flood, or other weather-related conditions. The drought, flood, or other weather-related condition must be of such severity that an area affecting the taxpayer area is designated eligible for federal assistance. To qualify for deferral, the taxpayer must show that he or she sold livestock in excess of the number that would ordinarily have been sold had there been no drought, flood, or other weather-related condition. Thus, this election applies only to sales in excess of normal or usual sales [I.R.C. §451(e)].

If **any** livestock are sold because of weather-related conditions, the taxpayer may be eligible for an exception to the general rule that the sales proceeds must be reported in the year received. To defer income to the next year, the following requirements must be met:

1. The taxpayer's principal business must be farming as defined in I.R.C. §6420(c)(3).
2. The taxpayer must use the cash method of accounting.
3. The taxpayer must show that the livestock would normally have been sold in the following year.
4. The weather-related conditions that caused an area to be declared eligible for federal assistance area must have caused the sale of livestock.

It is not necessary that the livestock be raised or sold in the declared disaster area, just that the weather-related condition that caused an area to be declared eligible for federal assistance caused the sale of the livestock. Also, the sale can take place before or after an area is declared eligible for federal assistance as long as the same weather-related condition caused the sale.

The number of animals that would normally be sold is determined primarily from the taxpayer's past history. If the taxpayer usually holds all calves until the year after they are born before selling them, but was forced because of weather-related conditions to sell them in the year they were born, the proceeds from this sale may be reported in the year following the year of the sale.

Due Date of Election

The due date of the election depends on the classification of the livestock.

1. If the livestock is held for sale in the ordinary course of business, the election must be made by the due date of the return (including extensions) for the tax year in which the drought sale occurred.

2. If the livestock is held for draft, breeding or dairy purposes, then beginning with tax years for which the return is due after December 31, 2002, the election can be made any time in the 4-year replacement period for the postponement of gain from sales caused by a disaster that resulted in a disaster area declaration under I.R.C. §1033(e)(2).

Options for Deferring Income

The two weather-related sales of livestock tax provisions have similar but different requirements. Weather-related sales of breeding stock could qualify for either provision. Figure 9 compares and contrasts the requirements and tax benefits. Affected taxpayers can determine which provision provides the greatest tax benefit.

FIGURE 9 COMPARISON OF WEATHER-RELATED SALES OF LIVESTOCK TAX CONSEQUENCES

Requirements for Weather-Related Sales of Livestock	Alternative Weather-Related Tax Provisions	
	Postpone gain by purchasing replacements [I.R.C. §1033(e)]	Defer income for 1 year [I.R.C. §451(e)]
Tax provisions provides for	Gain is deferred if replacement requirements are met within the next 2 (or 4) years.	Recognition of income is postponed by 1 year.
Tax provision is allowed only for	Sales in excess of normal practice	Sales in excess of normal practice
Qualifying livestock	Draft, breeding, or dairy livestock	All livestock
Requirement that area be designated eligible for federal assistance	No, but designation increases replacement period from 2 to 4 years	Yes
Weather-related condition must have caused the sale	Yes	Yes
Livestock must have been sold in the designated assistance area.	No	No
Livestock must be located in the designated assistance area	No	No
Purchase of replacement livestock required	Yes	No
Basis in replacement livestock	Must be reduced by the amount of gain deferred	N/A
Deadline for replacement	Generally 2 years after the year-end of the tax year of sale but 4 tax years after the year of sale if an area is designated eligible for federal assistance because of the condition that caused the sale	N/A
Deadline for making the election	2 years after the year-end of the tax year of sale	Generally, due date of tax return for year of sale, but 4 years after year of sale for sales that qualify for the 4-year replacement period under I.R.C. §1033(e)(2)

Notice 2006-82

A Web site can help taxpayers and tax preparers determine the replacement period for livestock sold on account of drought

Background

I.R.C. §1033(a) generally provides for nonrecognition of gain when property is involuntarily converted and replaced with property that is similar or related in service or use. If livestock (other than poultry) are held for draft, breeding, or dairy purposes, a sale or exchange in excess of the number that would be sold following the taxpayer's usual business practices is treated as an involuntary conversion if the sale or exchange is made solely on account of drought, flood, or other weather-related conditions.

If a sale or exchange of livestock qualifies as an involuntary conversion and is made solely on account of drought, flood, or other weather-related conditions that result in the area being designated as eligible for assistance by the federal government, I.R.C. §1033(e)(2)(A) provides that the replacement period ends 4 years after the close of the first tax year in which any part of the gain from the conversion is realized.

The IRS can extend this replacement period on a regional basis if the weather-related conditions that resulted in the area being designated as eligible for assistance by the federal government continue for more than 3 years. This provision is effective for tax returns due (without regard to extensions) after December 31, 2002.

Persistent Drought

If a sale or exchange of livestock is treated as an involuntary conversion on account of drought, **the replacement period is extended until the end of the taxpayer's first tax year ending after the first drought-free year for the applicable region.** The first drought-free year for the applicable region is the first 12-month period ending on August 31 that meets both of the following criteria:

3. It ends in or after the last year of the taxpayer's 4-year replacement period, and
4. It does not include any weekly period for which exceptional, extreme, or severe drought is reported for any location in the applicable region.

The applicable region is the county that experienced the drought conditions on account of which the livestock was sold or exchanged and all counties that are contiguous to that county.

U.S. Drought Monitor Maps

A taxpayer may determine whether exceptional, extreme, or severe drought is reported for any location in the applicable region by reference to U.S. Drought Monitor maps archived at www.drought.unl.edu/dm/archive.html. The IRS, after consultation with the National Drought Mitigation Center, will publish in September of each year a list of counties for which exceptional, extreme, or severe drought was reported during the preceding 12 months. Taxpayers may also use this list to determine whether a 12-month period ending on August 31 of a calendar year includes any period for which exceptional, extreme, or severe drought is reported for a location in the applicable region.

The notice applies to tax years ending after September 25, 2006.

[Notice 2006-82, 2006-39 IRB 529]

Example 1. Extension of Replacement Period

Dusty Rhodes, a calendar year taxpayer, raises cattle in Sere County. In 2002, all of Dusty's cattle held for breeding purposes were sold solely on account of drought conditions in Sere County. Under Dusty's normal business practices, only 25% of his cattle held for breeding purposes would have been sold in 2002. In 2002, the Secretary of Agriculture designated Sere County as eligible for federal assistance on account of the drought conditions. Thus, 75% of Dusty's sale is treated as an involuntary conversion.

Because Sere County is designated as being eligible for federal assistance on account of the drought conditions, Dusty's replacement period ends on December 31, 2006.

Under Notice 2006-82, Dusty's replacement period is extended until the end of his first taxable year ending after the first drought-free year for the applicable region. The applicable region is the county that experienced the drought conditions on account of which the livestock was sold (Sere County) and all counties contiguous to Sere County (Dry, Arid, Baked, and Parched counties).

For the 12-month period ending August 31, 2006, severe drought conditions were reported on U.S. Drought Monitor maps for all counties in the applicable region. For the 12-month period ending August 31, 2007, the only drought conditions reported for the applicable region on U.S. Drought Monitor maps were severe drought conditions for Parched County for the first week in September 2006. For the 12-month period ending August 31, 2008, U.S. Drought Monitor maps do not report drought conditions for any county in the applicable region.

Accordingly, the 12-month period ending August 31, 2008, is the first drought-free year for the applicable region, and Dusty's replacement period is extended through December 31, 2008 (the last day of his first taxable year ending after the first drought-free year for the applicable region).

Notice 2006-91

As promised in its initial guidance reflected in Notice 2006-82, 2006-39 IRB 529, the IRS has provided a list of counties and parishes for which exceptional, severe, or extreme drought was reported during the 12-month period ending August 31, 2006. This 12-month period isn't "drought-free" year for any region that includes a county or parish on the list. The period for replacing livestock is now extended under I.R.C. §1033(e)(2), for taxpayers who qualified for four-year replacement period for livestock sold or exchanged due to drought and that period was set to expire at end of 2006.

[Notice 2006-91, 2006-42 IRB 688]