AGRICULTURAL ISSUES

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Corrections for all chapters and the *2011 National Income Tax Workbook Update* (January 2012) are posted as they become available at `http://www.taxworkbook.com` (User Name: class2011 Password: class2011).

INTRODUCTION Agriculture continues to evolve, and the distinction between farm and nonfarm activities may be blurred. Because several tax benefits are available only to farmers, a tax preparer must know the rules and make the best decision possible.

Many farms specialize in a limited number of crop or livestock enterprises and focus on the production of a commodity, such as U.S. No. 2 yellow corn. A growing number of farms produce products such as organic foods for niche markets and farmers markets. Some agricultural activities involve plants with preproduction periods exceeding 2 years and special accounting procedures. Other activities may involve processing agricultural commodities, which raises the question: Where do farming activities end and the related nonfarm activities begin? Because there are tax benefits that are available only to farmers—such as estimated tax payment relief, farm

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income averaging, deductions for soil and water conservation expenses, and increased limits on deducting charitable contributions of conservation easements–this distinction can be important.

The first three issues in this chapter discuss some of the tax issues arising from the changes in agriculture. Issue 1 uses the context of vineyards and wineries to review some basic concepts applicable to all farms. Issue 2 discusses whether activities should be reported on Schedule F (Form 1040), Profit or Loss From Farming, or Schedule C (Form 1040), Profit or Loss From Business (Sole Proprietorship), continuing to use vineyard and winery illustrations. Issue 3 discusses the reporting of income and expenses from production for farmers markets and community-supported agriculture activities. Issues 4–6 apply the like-kind exchange and casualty loss rules in a farm setting, while Issues 7–9 address concerns that are especially farm-oriented.

ISSUE 1: VINEYARDS AND WINERIES

This section explains the requirements for capitalizing operating expenses incurred before fruit and nut trees and vines become productive. It also reviews tax law provisions that offer different definitions of the term *gross income from farming*.

The IRS published an updated *Wine Industry Audit Technique Guide* in March 2011, which provides an overview of the farming (vineyard), manufacturing (winery), and marketing phases of the industry. The guide for IRS agents also discusses the capitalization of preproduction period expenses and other tax accounting issues. It is accessible online at `http://www.irs.gov/businessess/small/article/0,,id=239115,00.html`.

Capitalization of Preproduction Expenses

The uniform capitalization (unicap) rules of I.R.C. § 263A generally require all direct and some indirect production costs incurred for plants that have a preproductive period of more than 2 years to be capitalized during the plant's preproductive period. This generally applies to orchards, groves, and vineyards (OGV), as well as nurseries.

The preproductive period for plants that will have more than one crop or yield is the period before the plant will bear its first marketable crop or yield. National average preproductive periods are used to determine if a tree or vine's preproductive period exceeds 2 years.

The direct and indirect costs that must be capitalized (rather than expensed and deducted currently) are deducted through depreciation during the OGV's productive period [I.R.C. § 263A(a)(1) and Treas. Reg. § 1.263A-1(a)(3)(v)].

Example 16.1 Preproduction Expenses

Betty Chardonnay, a calendar-year taxpayer, invested $120,000 to establish 10 acres of grapes during the period that began with planting the seedlings in 2007 and ended when the vines became commercially productive on August 15, 2011. The $120,000 includes $10,000 for the acquisition and initial planting of seedlings and $110,000 for the costs of cultivating, maintaining, spraying, fertilizing, and other cultural practices, as well as the tax depreciation, repairs, farm overhead, real estate taxes, and interest expense on debt directly attributable to the vines [I.R.C. § 263A(f) and Treas. Reg. § 1.263A-4(b)(1)(i)].

Betty can begin depreciating the $120,000 capitalized cost using the straight-line method over the vines' 10-year MACRS recovery period and the half-year convention on her 2011 federal income tax return. The costs she incurs after August 15, 2011, are deducted as ordinary farming expenses [Treas. Reg. § 1.263A-4(b)(2)(i)(C)(2)].

Practitioner Note Some OGVs Are Not Directly Affected

Producers with OGVs established before 1986 or acquired after the end of the preproductive period are not directly affected by the unicap rules. Only new or replacement plantings with a preproductive period of more than 2 years are affected. I.R.C. § 263A(d)(2) also provides an exception to the unicap rules when productive plants must be replaced because of disease, pests, drought, freezing temperatures, or other casualty.

Election Out of Capitalization

A producer may elect out of the unicap rules and currently deduct preproduction period costs that would otherwise be capitalized under I.R.C. § 263A. A producer who elects out must treat the plants as I.R.C. § 1245 property, so that any subsequent gain on their sale is ordinary income to the extent that their cost would have been capitalized and depreciated if the taxpayer had not elected out of capitalizing preproduction expenses [Treas. Reg. §1. 263A-4(d)(4)(i)].

Furthermore, the taxpayer and any related party must use the alternative depreciation system (ADS) for **any** property used predominantly in a farming business that was placed in service in a year for which the election was in effect [Treas. Reg. §1. 263A-4(d)(4)(ii)]. Related parties include the taxpayer's spouse, children under 18 years of age at the end of the tax year, and entities (corporations and partnerships) that are at least 50% owned by the taxpayer or members of the taxpayer's family.

Example 16.2 Effect of Election Out on Gain on Disposition

Assume that Betty Chardonnay from Example 16.1 elected out of capitalizing her $120,000 of preproduction expenses when she planted the grapevines in 2007 and that in 2013 she sells the grapevines for $100,000.

Because Betty deducted the $120,000 of expenses each year as they were incurred, she has no basis in the vines when she sells them, and she realizes a $100,000 gain. All of the gain is subject to the I.R.C. § 1245 recapture rules and is treated as ordinary income.

Example 16.3 Effect of Election Out on Other Depreciation

If Betty (from Examples 16.1 and 16.2) purchases $300,000 in farm equipment in 2011, her potential depreciation deductions vary dramatically. If Betty capitalizes the vines' preproduction expenses, she can depreciate her $300,000 investment over the 7-year MACRS general depreciation system (GDS) recovery period using the 150% declining-balance (DB) method. If Betty elects to not capitalize the preproduction expenses, she must use straight-line (SL) depreciation over the 10-year ADS recovery period. Figure 16.1 shows her comparative cost recovery for the $300,000 expenditure during the first 3 years–$134,610 using GDS and $75,000 using ADS.

Figure 16.1 Comparison of GDS and ADS Depreciation

	GDS	ADS
Tax Year	150% DB over 7 years	SL over 10 Years
2011	$32,130	$15,000
2012	57,390	30,000
2013	45,090	30,000
Total	$134,610	$75,000

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Planning Pointer Capitalizing vs. Deducting Preproduction Costs

Farm producers should evaluate the options of capitalizing or deducting preproductive period expenses. If the OGV activity subject to the unicap rules is a relatively small part of the farming business and there is a substantial investment in other depreciable assets, the more rapid MACRS depreciation may provide more tax benefits than the election to currently deduct preproduction expenses.

I.R.C. § 179 Expensing

Because the capitalized direct and indirect costs are not considered to be placed in service until the OGV becomes productive, they are not eligible for I.R.C. § 179 expensing either during the preproductive period or when the OGV becomes productive.

Purchases of OGVs that are already in production are not subject to the unicap rules. A portion of the purchase price is allocated to the OGV activity and depreciated over the 10-year MACRS life. Taxpayers could argue that a purchase of an established OGV is eligible for the I.R.C. § 179 deduction because the OGV meets the three I.R.C. § 179(d)(1) requirements for eligible property:

1. Tangible property to which I.R.C. § 168 applies
2. I.R.C. § 1245 property as defined in I.R.C. § 1245(a)(3)
3. Property acquired by purchase for use in the active conduct of a trade or business

Gross Income from Farming

The Internal Revenue Code and Treasury regulations use the terms *gross income from farming* and *farm income* as a part of the threshold requirements for several income tax provisions. However, the terms have slightly different definitions from one provision to another. Different definitions of *gross income from farming* are used for these tax benefits:

- Relief from the estimated tax payment requirements [Treas. Reg. § 1.6073-1(b)(2)]
- Allowance of a deduction for soil and water conservation expenditures [Treas. Reg. § 1.175-3]
- A 100%-of-contribution base limit on deducting charitable contributions of conservation easements [I.R.C. § 170(b)(1)(E)(v), by reference to I.R.C. § 2032A(e)(5)]

Farm income is also defined in the following provisions:

- Income averaging for farmers [I.R.C. § 1301(b)(3), by reference to I.R.C. § 263A(e)(4)]
- Deferral of gain from weather-related sales of livestock [I.R.C. §§ 451(e)(2), by reference to I.R.C. § 6420(c)(3)]

Estimated Tax Penalty Exception

A qualified farmer is not required to make quarterly estimated tax payments. To qualify for the exception, at least two-thirds of the taxpayer's total gross income for the current or immediately preceding tax year must be from farming or fishing. If a joint return is filed, the gross income of both spouses is included.

Gross income for estimated tax purposes is not the same as the total income shown on line 22 of Form 1040, U.S. Individual Income Tax Return. *Total gross income* is all income received in the form of money, goods, property, or services that is not exempt from income tax. It is not reduced by business, capital, or other losses.

IRS Publication 225, *Farmer's Tax Guide* (2010), page 84, states that *gross income from farming* is the total of the following amounts:

- Gross income reported on Schedule F (Form 1040), Profit or Loss From Farming
- Gross farm rental income reported on Form 4835, Farm Rental Income and Expenses
- Gross farm income from Parts I and II of Schedule E (Form 1040), Supplemental Income and Loss
- Gains from the sale of livestock used for draft, breeding, dairy, and sporting purposes reported on Form 4797, Sales of Business Property

Gross farm income does not include wages received as a farm employee or gains from the sale or disposition of land or depreciable farm machinery.

Example 16.4 Qualifying as a Farmer

Betty Chardonnay, from Example 16.1, sold $25,000 of grapes to the neighboring winery in 2011 and earned $150,000 in her nonfarm employment, for a $175,000 total gross income. Because only 14.3% ($25,000 ÷ $175,000) of her gross income is farm income, Betty does not qualify as a farmer for estimated tax purposes for 2011 on the basis of her 2011 income.

Betty could meet the two-thirds test for 2011 based on her 2010 income. If Betty sold $100,000 of grapes in 2010 and earned no more than $50,000 in her off-farm job, she would meet the two-thirds test and be a qualified farmer for estimated tax purposes for both 2010 and 2011.

Practitioner Note Special Rules for Estimated Tax

A qualified farmer for 2011 is not required to pay estimated tax if his or her 2011 tax return is filed and all of the tax due is paid by March 1, 2012. If the 2011 return will be filed later, a farmer is required to make only one estimated tax payment, which is due January 17, 2012.

If an estimated tax payment is required, the total prepayments (from income tax withholding, a prior-year credit-elect, and the estimated payment) must be at least 66.67% of the total tax shown on the 2011 tax return or 100% of the total tax shown on the farmer's 2010 return.

Soil and Water Conservation Expense Deduction

I.R.C. § 175 allows taxpayers with farm income to deduct qualified soil and water conservation expenditures, limited to 25% of the taxpayer's gross income from farming. Treas. Reg. § 1.175-1 defines *gross income from farming* as income derived from the production of crops, fish, fruits, other agricultural products, or livestock. Gains from the sale of draft, breeding, and dairy (but not sporting) livestock are included. Gains from the sale of assets such as farm machinery or from the disposition of land are excluded.

The only difference between *gross farm income* for the estimated tax provisions and for the soil and water conservation expense deduction is the latter provision's exclusion of gains from the sale of sporting livestock.

Example 16.5 Deductible Expenses

Betty Chardonnay, from Example 16.4, had gross farm income of $25,000 in 2011, and she spent $5,000 for construction of earthen structures to reduce erosion in her vineyard.

Betty can deduct the $5,000 soil and water conservation expenditure on line 12, "Conservation expenses," of her 2011 Schedule F (Form 1040) because it did not exceed the $6,250 amount that is 25% of her $25,000 gross farm income.

Conservation Contribution Deduction

I.R.C. § 170(b) places percentage limitations on an individual's charitable contribution deductions. In general, the limit is 20%, 30%, or 50% of the contribution base, which is adjusted gross income (AGI) without reduction for any net operating loss (NOL) carryback to the tax year. Contributions that are not currently deductible because of the percentage limits carry over for up to 5 years.

Before 2006, the limit for a donation of a qualified conservation interest was 30% of the contribution base. Temporary law changes increased the limit to 50% for most taxpayers for transfers made through 2011, with a 15-year carryforward. However, the limit for farmers and ranchers is 100% of the contribution base for qualified conservation contributions of property that is used in agriculture or livestock production (or is available for such use) if the donation is made before 2012 [I.R.C. § 170(b)(1)(E)(iv)(I)].

A qualified farmer or rancher for this provision must have gross income from the trade or business of farming that exceeds 50% of his or her total gross income for the tax year of the donation. I.R.C. § 170(b)(1)(E)(v) defines *farming* by referring to its definition for the estate tax special-use valuation rules. This definition includes cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, feeding, caring for, training, and management of animals) on a farm; handling, shearing, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than half of the commodity; and planting, cultivating, caring for, or cutting trees, or preparation (other than milling) of trees for market [I.R.C. § 2032(A)(e)(5)].

Weather-Related Sales of Livestock

When drought, flood, or other weather-related conditions cause a cash-basis farmer to sell more livestock than is the farmer's normal business practice, I.R.C. § 451(e) permits the farmer to elect a 1-year deferral for including the additional income from the extra sales. The taxpayer's principal trade or business must be farming within the meaning of I.R.C. § 6420(c)(3), a gasoline excise tax provision that defines farming similarly to I.R.C. § 2032(A)(e)(5).

Time spent is not necessarily the measurement of a taxpayer's principal trade or business. A cattle rancher had a full-time off-farm job that paid him a $65,000 salary. He also participated in raising livestock for 750–1,000 hours per year, while his spouse devoted 200–300 hours per year to the ranch. The ranch had no other employees. It generated about $121,000 in average annual gross income (total sales less cost of items purchased for resale)—which was about 65% of the taxpayer's total gross income. Based on those facts, the IRS held that the rancher's principal activity was farming [P.L.R. 89-28-050 (April 18, 1989)].

Example 16.6 Different Definitions of Farm Income

Laura and Dan Forest will file a joint return for 2011. Laura is employed in an off-farm job; they also grow wine grapes, raise feeder cattle, and occasionally sell standing timber. Figure 16.2 lists the income and loss items included on their federal income tax return and identifies whether those items count as farm income for four tax benefits.

The $2,500 investment loss is not included in gross income [I.R.C. § 61(a)(3) includes only "gains derived from dealings in property"]. The $3,500 gain from I.R.C. § 1245 depreciation recapture is included in total gross income but is not included in the gross income from farming under any of the definitions. The $90,000 gain on the sale of timber is not included in farm income for estimated tax and soil and water conservation purposes, but it is included for purposes of the conservation contribution deduction and weather-related sales of livestock.

Because the definitions of gross income from farming differ, the Forests qualify for three special tax benefits for farmers and do not qualify for one benefit:

1. For estimated tax purposes, the Forests' $65,000 of gross income from farming is only 33.46% of their $194,250 total gross income for 2011. Thus, Laura and Dan do not qualify as farmers for estimated tax purposes on the basis of their 2011 income. They might qualify based on their 2010 income.
2. If they incurred soil and water conservation expenses in 2011, their deduction is limited to $16,250 ($65,000 × 25%). They can carry expenditures in excess of the $16,250 limit into future tax years.
3. For purposes of the charitable contribution of a conservation easement deduction, 79.79% ($155,000 ÷ $194,250) of their gross income is from farming. Therefore, they qualify for the 100%-of-contribution base limit if they donated a conservation easement.
4. Laura and Dan's principal trade or business is farming for purposes of reporting weather-related sales of livestock, because 79.79% of their gross income is from farming.

Figure 16.2 Laura and Dan Forests' Gross Income from Farming

Income Item	Tax Return Income	Total Gross Income	Gross Income from Farming for Estimated Tax and for Soil and Water Conservation Expense Deduction	Gross Income from Farming for Donation of Conservation Easement and for Weather-Related Sales of Livestock
Laura's off-farm salary	$ 35,000	$ 35,000		
Interest income	750	750		
Capital loss on stock	(2,500)			
Farm income [sale of grapes and feeder cattle included on line 9, Schedule F (Form 1040)]	60,000	60,000	$60,000	$ 60,000
Gain from sale of cull raised breeding stock	5,000	5,000	5,000	5,000
I.R.C. § 1245 gain (from sale of planter used in vineyard)	3,500	3,500		
Gain on sale of timber	90,000	90,000		90,000
Total	$191,750	$194,250	$65,000	$155,000

Farm Income Averaging

An individual can use farm income averaging for his or her farm business income, whether or not farming is his or her principal trade or business. The definition in Treas. Reg. § 1.1301-1(e)(1)(i) states, "Farm income includes items of income, deduction, gain, and loss attributable to the individual's farming business."

Income from a farming business is any farm income or gains minus the related expenses or losses that are allowable as deductions in computing taxable income:

- Gain from the sale or other disposition of property (other than land) that has been used regularly in the farm business for a substantial period of time is included.
- Gain from the sale of timber is not included in farm income.
- Shareholders of an S corporation engaged in a farming business can treat their compensation from the corporation that is attributable to the farming business as farm income.

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ISSUE 2: FARM OR NONFARM BUSINESS INCOME Income from growing and harvesting commodities is generally reportable on Schedule F (Form 1040), but processing activities are often reportable on Schedule C (Form 1040), even when they are conducted on the farm.

Farming generally includes activities normally incident to growing, raising, or harvesting an agricultural product. A taxpayer who does not work full-time in farm operations may still be considered a farmer if his or her involvement is significant.

- A taxpayer who participated to a significant degree in the process of raising ducklings and bore a substantial risk of loss was regarded as a farmer in *Maple Leaf Farms, Inc. v. Commissioner,* 64 T.C. 438 (1975).
- A taxpayer operating a commercial feedlot for cattle owners was considered a farmer in *Hi-Plains Enterprises, Inc. v .Commissioner*, 60 T.C. 158 (1973).
- Taxpayers who entered into a contract with a nursery for the nursery to bud and cultivate orange tree seedlings on the nursery's premises persuaded two of three judges that they were farmers in *Maple v. Commissioner*, 440 F.2d 1055 (9th Cir. 1971), *aff'g* T.C. Memo. 1968-194.
- A doctor who leased 40 brood cows, contracted the cattle breeding and management responsibilities to an independent party, and only took delivery of the calves after weaning was held to be a farmer in *Duggar v. Commissioner*, 71 T.C. 147 (1978).

Suppliers and Harvesters

I.R.C. § 448(b)(1) generally allows a farming business to use the cash receipts and disbursements method of accounting. If a taxpayer also performs other activities, the taxpayer generally cannot report the nonfarming activities under the cash method. An example of a nonfarming activity is a processing activity that is not normally incident to growing, raising, or harvesting an agricultural commodity. Businesses that supply farm inputs or harvest crops without an ownership interest in the crops are not treated as farming businesses.

In *Ward AG Products, Inc. v. Commissioner,* T.C. Memo. 1998-84, the Tax Court held that a supplier who sold seed, fertilizer, pesticides, herbicides, and farm hardware to farmers and provided free consulting services to his customers did not qualify as a farm or farmer for accounting purposes. The supplier visited his customers' farms daily, inspected their soil and crops, took leaf and soil samples, and advised them about fertilizers, herbicides, and pesticides, showing them how to apply the chemicals. He charged for testing soil samples, but he did not charge for advice. Because he had no control or management of a farm operation, and did not bear a substantial risk of loss from farming, the supplier was required to use the accrual method and account for his merchandise inventories.

However, the IRS concluded that a seed corn company that normally grew about 50% of its seed corn itself and entered into growing contracts with other farmers to produce the other 50% of the seed corn was a farmer, was in a farming business, and could use the cash method of accounting [P.L.R. 90-09-003 (November 28, 1989)].

Practitioner Note Activities That Are Farming

Farming activities under I.R.C. § 448 include only activities that are normally incident to growing, raising, or harvesting an agricultural product. When seed corn is harvested, it is sorted into ears suitable for seed corn and ears that will be shelled and sold as commercial corn. The seed corn ears are then shelled, processed, and bagged for sale as hybrid seed corn.

A grain harvester who contracted with other individuals to harvest their crops and transport the crops to a specified location was not engaged in a farming business, the IRS determined in T.A.M. 97-48-002 (June 27, 1997). The grain harvester was paid an established rate per acre and repeated the activity for other individuals. He did not raise or grow the grain that he cut and hauled, nor did he own or lease the land on which the crops grew. Because he merely provided a service to farmers by cutting and hauling grains, he was not subject to the 150% limit on MACRS declining-balance depreciation that applies to farm businesses.

The taxpayer in the T.A.M. had not treated the harvesting as farming; the IRS agent who was examining the harvester's tax return was trying to limit the harvester's depreciation deductions for the harvesting and hauling equipment to the 150% rate for farm operations.

An active farmer may engage in a limited amount of custom hire without risking his or her treatment as a farmer.

Practitioner Note Farmer Providing Machine Work (Custom Hire)

Some operating farmers perform one or more operations (such as planting, spraying, or harvesting) for other farmers in their neighborhood. In other instances, an operating farmer performs all of the activities necessary to grow and harvest a crop for a landowner (custom farming). If the income and expenses associated with custom work are minor, they are included on Schedule F (Form 1040). The 2011 IRS instructions for Schedule F (Form 1040) state that custom hire income is reported on line 7a if the payment is received through a merchant card or third-party network and on line 7b if it is not.

Processing of Commodities

The definitions of farms and farming discussed in Issue 1 describe farming activities as including

- cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, feeding, caring for, training, and management of animals) on a farm; and
- handling, shearing, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than half of the commodity.

Treas. Reg. § 1.263A-4(a)(4)(ii) states that the term *farming business* "includes processing activities that are normally incident to the growing, raising or harvesting of agricultural or horticultural products," but it does not include processing of commodities beyond the activities that prepare the commodity for its initial sale. Activities that are not farming should be reported on Schedule C (Form 1040).

Example 16.7 Vineyards and Wineries

Cab Bernet has produced wine grapes for many years. After sorting out the diseased and immature grapes, he sells the remaining grapes to a nearby winery. He has properly reported the vineyard's income and expenses on Schedule F (Form 1040).

In 2011, Cab has a record crop of grapes, and the winery will purchase only 75% of their production, paying him about $60,000. The neighboring winery operator suggests two alternatives for the remainder of the crop:

1. Cab could crush some of the grapes and market the juice to amateur winemakers.
2. Cab could crush the grapes and process the juice into a niche wine that would be aged for 2 years before it is bottled and sold.

Question 1.
How should Cab report the income and related expenses if he crushes some grapes and markets the juice?

Answer 1.
Crushing and pressing grapes to produce juice is not a farming activity, so the costs of producing the juice and income from the juice sales are reported on Schedule C (Form 1040). Thus, Cab must complete both a Schedule F (Form 1040) and a Schedule C (Form 1040) to report his business activities as a sole proprietor.

Cab reports his sale of grapes to the nearby winery on line 2b of Schedule F (Form 1040). He also reports the $20,000 wholesale value of the grapes he selected to make juice on the same line.

He then enters the $20,000 wholesale value of the grapes he used for juice as an inventory purchase in Part III, Cost of Goods Sold, of Schedule C (Form 1040).

Question 2.
How should Cab report the income and expenses if he chooses to process some grapes into wine?

Answer 2.
If Cab processes grapes into wine, the wholesale value of the grapes is reported as income on line 2b of Schedule F (Form 1040). The same wholesale value is reported as an inventory purchase in Part III of Schedule C (Form 1040).

Question 3.
Can Cab use the cash method of accounting for his juice and wine activities that are not farming activities even though they must be reported on Schedule C (Form 1040)?

Answer 3.
Yes, I.R.C. § 446 includes the cash method in the list of permissible methods that most taxpayers can use to compute taxable income. I.R.C. § 448 provides some exceptions, but none of the exceptions apply to Cab. Rev. Proc. 2001-10, 2001 C.B. 272, generally permits taxpayers with annual average gross receipts of $1,000,000 or less to use the cash method of accounting and opt out of inventory accounting, and Cab's income is below this limit.

Treas. Reg. § 1.446-1(a)(4)(i) states that if the production, purchase, or sale of merchandise of any kind is an income-producing factor, the taxpayer must take inventories (that is, any merchandise on hand at the beginning or end of the year) into account in computing taxable income. Farmers can ignore inventories when computing taxable income under the cash method [Treas. Reg. § 1.471-6(a)], so Cab could include grape production–but not juice and wine production–under this exception.

Cab must consider his beginning and ending quantities of grape juice and wine when determining his taxable income, even if he opts out of inventory accounting under Rev. Proc. 2001-10, because it then requires taxpayers to treat inventoriable items as materials and supplies that are not incidental. This entails forgoing a cost deduction until the items are used or consumed in the business.

If Cab had no juice and wine on hand at the beginning of 2011 and had processed but not yet sold juice and wine costing $60,000 at the end of 2011, he cannot deduct the $60,000 production cost in computing his 2011 taxable income.

Example 16.8 Nongrower's Production of Wine

Elena Ortiz operates a winery near the interstate highway. She purchases juices made from several varieties of grapes and processes the juices into wines that she sells in her tasting room. She has received several awards for her wines in international competitions.

Because Elena is not involved in the process of farming and does not bear the risk of loss in growing the grapes, she is not a farmer. She reports the receipts and expenses from her winery on Schedule C (Form 1040).

2011 Schedule F (Form 1040)

Part I of Schedule F (Form 1040) has been revised for 2011, and the line numbers for reporting farm income are not the same as in prior years. The payments reported on lines 1a and 2a for *specified sales* of resale or raised products are those received through a merchant card or a third-party network. These generally will be reported to the farmer on Form 1099-K, Merchant Card and Third Party Network Payments. Merchant cards include, but are not limited to, Visa® and MasterCard®. Third-party networks include, but are not limited to, Paypal® and Google Check-out®.

The IRS instructions for Schedule F (Form 1040) state that merchant card and third-party network transactions are to be reported on line 1a or 2a even if a Form 1099-K is not received. Other sales of commodities are reported on lines 1b and 2b.

Figure 16.3 shows Part I of the 2011 Schedule F (Form 1040).

Figure 16.3 2011 Schedule F (Form 1040)

SCHEDULE F (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Farming
▶ Attach to Form 1040, Form 1040NR, Form 1041, Form 1065, or Form 1065-B.
▶ See Instructions for Schedule F (Form 1040).

OMB No. 1545-0074
2011
Attachment Sequence No. 14

Name of proprietor | **Social security number (SSN)**

A Principal crop or activity | **B Enter code from Part IV** ▶ | **C** Accounting method: ☐ Cash ☐ Accrual | **D Employer ID number (EIN), if any**

E Did you "materially participate" in the operation of this business during 2011? If "No," see instructions for limit on passive losses. ☐ Yes ☐ No
F Did you make any payments in 2011 that would require you to file Form(s) 1099 (see page F-3 of the instructions) . . . . . ☐ Yes ☐ No
G If "Yes," did you or will you file all required Forms 1099? . . . . . ☐ Yes ☐ No

Part I **Farm Income—Cash Method.** Complete Parts I and II (Accrual method. Complete Parts II and III, and Part I, line 9.)

1a	Specified sales of livestock and other resale items (see page F-3)	**1a**			
b	Sales of livestock and other resale items not reported on line 1a	**1b**			
c	Total	**1c**			
d	Cost or other basis of livestock or other items reported on line 1c	**1d**			
e	Subtract line 1d from line 1c			**1e**	
2a	Specified sales of products you raised (see page F-3)			**2a**	
b	Sales of products you raised not reported on line 2a			**2b**	
3a	Cooperative distributions (Form(s) 1099-PATR)	**3a**	**3b** Taxable amount	**3b**	
4a	Agricultural program payments (see page F-3)	**4a**	**4b** Taxable amount	**4b**	
5a	Commodity Credit Corporation (CCC) loans reported under election			**5a**	
b	CCC loans forfeited	**5b**	**5c** Taxable amount	**5c**	
6	Crop insurance proceeds and federal crop disaster payments (see page F-3):				
a	Amount received in 2011	**6a**	**6b** Taxable amount	**6b**	
c	If election to defer to 2012 is attached, check here ▶ ☐		**6d** Amount deferred from 2010	**6d**	
7a	Specified custom hire (machine work) income (see page F-3)			**7a**	
b	Custom hire income not reported on line 7a			**7b**	
8a	Specified other income (see page F-3)			**8a**	
b	Other income not reported on line 8a (see page F-3)			**8b**	
9	**Gross income.** Add amounts in the right column (lines 1e, 2a, 2b, 3b, 4b, 5a, 5c, 6b, 6d, 7a, 7b, 8a, and 8b). If you use the accrual method, enter the amount from Part III, line 50 ▶			**9**	

Draft as of 02/24/2011

Cross-Reference Payment Card Transactions

See the "IRS Issues" chapter of this book for more information about new Form 1099-K and reporting payment card transactions.

Activities Incident to Growing and Harvesting

Processing that is incidental to growing and harvesting a commodity is included in the term *farming business* [Treas. Reg. § 1.263A-4(a)(4)(ii)(A)]. For example, the extraction of oil from mint plants occurs in conjunction with harvest and, therefore, the extraction process fits within the definition of farming. The processing of poultry or livestock for meat is not considered farming [Treas. Reg. § 1.263A-4(a)(4)(iii)].

Further processing of agriculturally based products beyond their first marketable state is not considered farming and should be reported on Schedule C (Form 1040). This is likely to require an allocation of income and expenses. Some of the operations performed to convert commodities into their first marketable state are summarized in Figure 16.4. These activities qualify as farming activities.

Figure 16.4 On-farm Processing Activities That Qualify as Farming

Commodity	Operation	Authority
Fresh fruits and vegetables	Washing, grading, packing, and cooling	Treas. Reg. §§ 1.263A-4(a)(4)(ii) and 1.448-1T(d)(2)
Fresh fruits and vegetables	Storing on a farm of any agricultural or horticultural commodity in its unmanufactured state	I.R.C. § 6420(c)(3)(B) and Treas. Reg. § 48.6420-4(e)(1)
U-pick fruits and vegetables	Harvest performed by customer as part of purchase "No charge for consumption during harvest"	
Cotton	Ginning and baling	Treas. Reg. § 48.6420-4(d)
Grains (corn, wheat, rice, etc.)	Drying and storage	Treas. Reg. § 48.6420-4(d)
Honey	Processing honey for sale	
Maple sap	Harvest of maple sap is farming Processing sap into maple syrup or sugar is not farming	Treas. Reg. § 48.6420-4(e)(2)
Mint oil	Extraction of oil from plant	On-site distilling is normal part of mint harvest
Oleoresin	Harvesting of oleoresin from a living tree is farming Processing of oleoresin into gum spirits of turpentine or gum resin is not farming	Treas. Reg. § 48.6420-4(e)(2)
Tobacco	Drying and stripping—form varies by type of tobacco	Treas. Reg. § 48.6420-4(d)
Wool	Shearing	I.R.C. §§ 464(e)(1) and 6420(c)(3)

Farming purposes include raising, shearing, feeding, caring, training, or managing livestock, poultry, bees, or wildlife [I.R.C. § 48.6420-4(d)]. Gasoline used in connection with canning, freezing, packaging, or processing operations of agricultural commodities is not used for farming operations even though the operations are performed on a farm [I.R.C. § 48.6420-4(e)(1) and (2)].

ISSUE 3: FARMERS MARKETS AND COMMUNITY-SUPPORTED AGRICULTURE

Farmers markets have been around for a long time, but their popularity has increased in recent years, and their offerings have expanded. Community-supported agriculture arrangements allow some risk sharing and access to working capital.

The U.S. Department of Agriculture's *2011 National Farmers Market Directory* indicates that 7,175 farmers markets operate throughout the United States, as more farmers are marketing their products directly to consumers than ever before. In the past, farmers markets sold primarily whole fruits and vegetables. Now the products offered include more processed foods, meat and other livestock products, and nonfood items such as flowers, plants, and arts and crafts.

Cross-Reference Directory of Farmers Markets

A search engine for a national database of farmers markets is accessible on the U.S. Department of Agriculture's website at `http://search.ams.usda.gov/farmersmarkets/`.

In a community-supported agriculture (CSA) arrangement, sometimes known as *subscription farming*, growers and consumers share the risks and benefits of food production. Typically, members pledge in advance to cover the anticipated costs of the farm operation in return for shares of farm products. Thus, they share in the risks of farming, including poor harvests. Growers receive working capital and better prices for their crops. State sales tax and liability insurance can be significant issues.

Products Sold at Farmers Markets

Specific farmers markets differ in their orientation and therefore their rules and regulations. Many farmers markets are subject to state or local health board supervision and control. Example 16.9 lists the requirements for participation in one market.

Example 16.9 Lafayette (Indiana) Farmers Market

This 165-year-old market is open 3 days a week from May through October. It requires each vendor to produce at least 70% of all products (excluding food and beverages sold for immediate consumption) that the vendor sells. The vendor must purchase any products he or she did not produce directly from the producer. The market allows sales of the following items:

1. Vegetables, fruits, nuts, potted plants and herbs, cut flowers, and dried flowers that are "home grown" or "processed farm fresh" by the vendor
2. Fresh, homegrown food products that are minimally processed by the vendor (such as honey, syrups, jellies, jams, preserves, baked goods, persimmon pulp, dried spices and herbs, flour, cornmeal, unpopped popcorn, seeds, home-canned produce, cider and other pressed juices, dairy products, and vinegars)
3. Organic products–any of the previously listed products that are organically grown (or made from produce organically grown) on the vendor's own farm

Practitioner Note Organic Products

To sell organic products, the vendor must be listed as an organic farmer with the appropriate state department in Indiana or the state of his or her residence.

4. Farm produce and products (as previously described) purchased directly from other farms or producers in Indiana (limited to 30% of the vendor's offerings)
5. Farm produce or products (as previously described) obtained for resale directly from

a producer outside Indiana (limited to 30% of the vendor's offerings)

6. Concessions–food and beverages for sale and immediate consumption at the market
7. Arts, crafts, and miscellaneous handmade or handcrafted products approved by the market board

For further information, see http://www.lafayettefarmersmarket.com/default.htm.

Reporting Sales at Markets

As discussed in Issues 1 and 2 of this chapter, an individual may be a farmer for one income tax law provision but not for another, depending on a percentage of income from farming or what is defined as a farming activity. Individual farmers markets typically set rules for who is eligible to participate in the market as a vendor and what products can be sold.

A vendor might not qualify as a farmer for most of the tax provisions previously discussed. Vendors may need to file a Schedule C (Form 1040) in lieu of or in addition to Schedule F (Form 1040), depending on the activities performed. If both schedules are required, vendors must allocate the related expenses, as in Example 16.7.

Sales of raised produce and products purchased for resale in a farming business are generally reported in Part I of Schedule F (Form 1040).

Example 16.10 Sales at Farmers Markets

Jonathan McIntosh owns an apple orchard and a cider mill. Most of his apples are sold through a u-pick operation and to local grocery stores, but he also participates in a weekly farmers market. In addition to Jonathan's sales of baskets of fresh apples and jugs of cider, his daughter, Gala, began baking apple breads and making apple butter, which always sell quickly. They did not form a partnership.

Jonathan's apple sales are reported on Schedule F (Form 1040), but the McIntoshes must each report their sales of cider and prepared foods on a Schedule C (Form 1040).

Purchases for Resale

Vendors at farmers markets want to provide a variety of farm products for their customers. The first fresh strawberries or sweet corn typically command a premium price. But weather, diseases, insects, and other unexpected events can affect the kinds and quantities of products a vendor has available on a market day. Thus, vendors may buy products from other growers to supplement their homegrown production.

The cost of items purchased for resale is deductible when the items are sold or otherwise disposed of. When farm produce is purchased for resale and sold by a farmer, the income is reported on line 1a or 1b of Schedule F (Form 1040), and the acquisition cost is reported on line 1d. The line 1d cost is then deducted from line 1c (the total of the sales prices reported on lines 1a and 1b) to arrive at the gross income included on line 1e, as shown in Figure 16.3.

Example 16.11 Purchases for Resale

Tim Burr produces a variety of vegetables that he sells at the local farmers market, and he has developed a reputation for being the first vendor to have various local vegetables. This year, Tim's first sweet corn planting was killed by a late frost. Tim purchased 100 ears of corn from another grower for 55¢ an ear and resold all of them for $1 an ear. He does not accept payment cards at the market.

Tim reports his $100 of sweet corn sales on lines 1b and 1c, his $55 purchase cost on line 1d, and his $45 net income on line 1e of Schedule F (Form 1040).

Barter Transactions

Vendors at farmers markets often trade or swap products in barter transactions. Each producer must treat the value of the product given up in the trade as a sale of that product. Each producer must also treat the purchase of the product acquired as a purchase for resale. Because the traded products have equal values, the net effect is a wash for both producers.

Example 16.12 Barter Transactions

Tim, from Example 16.11, swaps two bushels of tomatoes valued at $50 ($25 a bushel × 2) to Kim Chee for 100 ears of sweet corn valued at $50 (50¢ an ear × 100). Each then sells the swapped vegetables at the market for $50.

Tim and Kim each report a $50 sale of vegetables acquired for resale on lines 1b and 1c of Schedule F (Form 1040) and a $50 purchase of vegetables for resale on line 1d, so that line 1e is zero. Each must also report a $50 sale of raised vegetables (tomatoes for Tim, corn for Kim) on line 2b of Schedule F (Form 1040). Thus, the amount included in gross income from farming on line 9 of Schedule F (Form 1040) is $50, and the expenses of growing the vegetables are still deducted in Part II of the form.

Charitable Contributions

When a farmers market closes for the day, vendors often donate leftover fruits and vegetables to a local food pantry or soup kitchen. Vendors want to know if they can claim a charitable contribution for these donations. The answer depends on whether the cost of raising the products is deducted as a business expense on the vendor's tax return.

If the cost of raising the products is deducted as a business expense on Schedule F (Form 1040), the taxpayer's basis in the products is zero. The taxpayer then cannot claim a charitable contribution for the raised product because the deduction is limited to the taxpayer's zero basis.

If the cost of raising the products is not deducted as a business expense on Schedule F (Form 1040), the cost generally can be deducted as a charitable contribution. A deduction at fair market value is not allowed because gain on the produce's sale would be ordinary income.

Example 16.13 Charitable Contributions

Tim, from Example 16.11, had purchased 100 ears of early sweet corn for 55¢ per ear, giving him a $55 basis in the corn he took to the farmers market. He also had three bushels of tomatoes he had raised in his greenhouse for sale at the market. It costs Tim about $10 a bushel to raise the tomatoes, and he deducts those costs as an expense on his Schedule F (Form 1040). Therefore, he has a zero basis in the tomatoes. Tim sold only 40 ears of corn and two bushels of tomatoes at the market, so after it closed, he gave the remaining bushel of tomatoes and 10 ears of corn to a nearby soup kitchen.

Tim's basis in the sweet corn was $5.50 (10 ears × 55¢), so he can claim a $5.50 charitable contribution deduction if he itemizes deductions.

Sales Taxes

There is no federal sales or use tax in the United States, but 45 states impose sales and use taxes on the retail sales of many goods and some services. Cities, counties, and many special-purpose districts may impose additional local sales taxes.

Only nine states have a sales tax on groceries, and those rates are all lower than the states' respective general sales tax rates. About 14 states allow a higher tax rate on prepared foods (snacks and meals) than the general sales tax rate. Definitions of items subject to sales taxes can vary considerably among states, so farmers selling products at farmers markets need to check the appropriate state's requirements. The requirements of three states are provided here for comparison purposes.

Practitioner Note Online Resource

The Federation of Tax Administrators (FTA) provides a table summarizing state tax rates on its website at `http://www.taxadmin.org/fta/rate/tax_stru.html`. The FTA site also includes links to the member states' websites.

Indiana

"Farm Markets" is the topic of Indiana Department of Revenue Sales Tax Information Bulletin 70 (May 2003). Vendors selling produce and most other food for human consumption are not required to charge sales tax on these items. However, the exemption for food items does not apply to items such as candy, soft drinks, and food sold for immediate consumption. Sales tax must be charged on the sale of sandwiches, soups, and other prepared food items for consumption at or near the sales premises. With local taxes added, the sales tax rate on prepared food can be as high as 9.0%.

Vendors selling arts, crafts, and other items not suitable or intended for human consumption must collect the 7.0% general Indiana sales tax. Taxable items include, but are not limited to, potholders, birdhouses, candles, cut flowers and floral arrangements, lawn and patio furniture, and decorative and ornamental items such as gourds, ornamental corn, and bittersweet.

A number of Indiana farmers sell items such as cut flowers and decorative plants that are reported as farm income on Schedule F (Form 1040), but which are also subject to sales tax.

North Carolina

The North Carolina Department of Revenue administers a 4.75% general sales tax on retail sales of tangible personal property. A number of counties impose a 2.0% or 2.25% local sales or use tax, and one county imposes a 0.5% transit tax.

All retail sales of food and food products are subject to the applicable state and local sales or use tax unless the sales are exempt or excluded. Sales for resale and school cafeterias are generally A grower's sales of farm products in their unmanufactured state are exempt only if they are made in the capacity of a producer, and not as a retail merchant.

Retail purchases of qualifying food are subject only to the 2% local rate of sales or use tax. Purchases of nonqualifying food are subject to both state and local taxes. Nonqualifying items include dietary supplements, food sold through a vending machine, prepared food, soft drinks, and candy. For prepared food, the maximum sales tax rate is 9.25% [North Carolina Department of Revenue Sales and Use Tax Technical Bulletins, "Section 19–Food and Food Products" (January 15, 2009)].

Wisconsin

Wisconsin Department of Revenue Publication 220, *Grocers* (October 2010), page 13, states that "an exemption from Wisconsin sales and use tax is provided for all *food and food ingredients* except *candy*, *dietary supplements*, *prepared food*, and *soft drinks*." It provides detailed definitions for each of these terms.

Page 18 of Publication 221, *Farm Suppliers And Farmers,* lists some taxable and tax-exempt sales by farmers. Sales of flowers, Christmas trees, and other decorative trees, plants, or shrubs are taxable, whereas sales of food and food products for human consumption (such as milk, meat, fish, fruits, vegetables, and grain) are exempt.

Wisconsin's general sales tax rate is 5%, and 62 counties impose an extra 0.5% county tax.

Community-Supported Agriculture

Community-supported agriculture (CSA) arrangements provide an opportunity for producers to add value to some or all of their production. Usually a farmer or group of farmers sells shares (also referred as subscriptions or memberships) to nonfarm individuals. These individuals then share in the farm's production of fruits and vegetables throughout the growing season, receiving a weekly box or bag or basket of seasonal produce. Dairy products, eggs, and meat are sometimes included.

Because they pay in advance, CSA members share in the risks of farming, including poor harvests due to unfavorable weather, insects, or plant diseases. Membership benefits include exposure to new or different vegetables and farm visits. Members may develop a relationship with the farmer and an understanding of how food is produced. CSA farmers benefit from advance payments to cover the anticipated costs of growing the products, risk sharing, and a predetermined market for the crops.

A CSA agreement is an alternative way of marketing a farm's production. Sales of subscriptions or memberships are income to the farm business and are reported in Part I of Schedule F (Form 1040). Expenses, including the expenses associated with drop-off or delivery of the weekly box, are reported on Schedule F (Form 1040).

If CSA agreements include processed products such as meat, cheese, flower arrangements, baked goods, or other products made from farm produce, the income from those sales and the expenses for processing are reported on Schedule C (Form 1040).

Practitioner Note Changes in Activities

If farmers add nonfarm activities to their business, their tax reporting and liability exposure may change.

- The new activities may require reporting on Schedule C (Form 1040).
  - The farmers may have to allocate the cost of hired labor between Schedules C and F (Form 1040) and file Form 941, Employer's Quarterly Federal Tax Return, in addition to Form 943, Employer's Annual Federal Tax Return for Agricultural Employees.
  - The farmers may owe sales tax on some sales.
- Their liability insurance for a farm business may not provide the needed coverage for nonfarm activities.

ISSUE 4: LIKE-KIND EXCHANGE OF EQUIPMENT

I.R.C. § 1031 requires taxpayers to postpone recognition of gain or loss on property they relinquish if they trade the property for *like-kind property.*

The gain or loss is postponed by not recognizing the gain or loss realized on the relinquished property and using the gain or loss to adjust the basis in the acquired property. Both the relinquished property and the acquired property must be used in a trade or business or held for investment [I.R.C. § 1031(a)(1)]. The acquired property is called *replacement property* in IRS guidance about subsequent depreciation. Unlike property that is acquired or relinquished in the exchange is called *boot,* and gain on its deemed sale is not deferred. The "Real Estate Issues" chapter of this book discusses like-exchange exchanges of real estate.

Personal Property

The term *like kind* is interpreted more narrowly for personal property than it is for real property. Regulations provide some clarity in the murky issue of whether personal property is like kind by providing two safe harbors for determining whether that property is like kind [Treas. Reg. § 1.1031(a)-2(b)(1)].

First Safe Harbor

The first safe harbor includes 13 of the General Asset Classes under the depreciation rules set out in Rev. Proc. 87-56, 1987-2 C.B. 674, as subsequently modified [Treas. Reg. § 1.1031(a)-2(b)(2)]. Because farm property is not included in those 13 classes, this safe harbor cannot be used to classify farm personal property as like kind.

Second Safe Harbor

Assets that are not within any of the specified 13 General Asset Classes are eligible for the second safe harbor–all of the 6-digit product classes within sectors 31 through 33 of the North American Industry Classification System (NAICS). Any two assets that are listed in the same 6-digit product class (other than the miscellaneous classes, which end in 9) are like-kind property [Treas. Reg. § 1.1031(a)-2(b)(3)].

However, the NAICS was written to classify industries rather than products, and use of the product classes to find like-kind property is somewhat confusing. The assets are classified by the industry that manufactures the assets, rather than by the taxpayer's industry. The NAICS can be found online at `http://www.census.gov/epcd/naics02/`.

Because most personal property (other than livestock) that is used in a farm business is included in NAICS Product Class 333111, "Farm Machinery and Equipment," farmers will generally qualify for I.R.C. § 1031 treatment when they exchange farm equipment for farm equipment.

Example 16.14 Exchange of Equipment

During 2011, Rachel Brown, a sole proprietor, made the trades shown in Figure 16.5.

Practitioner Note No Change to Prior Case Law

The safe harbors only provide an additional means of showing that two assets are like kind. They do not change or replace any case law or IRS rulings. Therefore, if two assets are not in the same asset or product class, they are still like-kind property if a court case or an IRS ruling treats them as like-kind property [Treas. Reg. § 1.1031(a)-2(a)].

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Figure 16.5 Rachel Brown's 2011 Trades

Property Transferred					Property Received			
Item	Original Basis	Depreciation Claimed	Adjusted Basis	FMV	Item	FMV	Boot Paid	Boot Received
Old tractor	$30,000	$24,486	$5,514	$10,000	New tractor	$60,000	$50,000	
Combine	$57,000	$32,558	$24,442	$40,000	Corn planter	$25,000		$15,000
2001 car*	$14,000	$ 7,000	$7,000	$4,000	2011 car	$20,000	$6,000	

* The car was used 50% for business and 50% for personal purposes.

The 2001 car was used 50% in Rachel's farm business and 50% for personal use. Rachel claimed depreciation on only the 50% business use. She expects her use of the 2011 car to be similar (half business, half personal). But whether Rachel's use of the 2011 car is more or less than 50% does not change her gain or loss on the 2001 car–it will only affect the depreciable basis of the 2011 car.

Old Tractor for New Tractor

The gain Rachel realizes on the exchange of tractors is shown in Figure 16.6. The trade qualifies as a like-kind exchange because the property she transferred and the property she received are both tractors. Rachel does not have to recognize any gain because no boot was received.

Figure 16.6 Deferred Gain on Tractor

Trade-in value of old tractor	$10,000
Adjusted basis of old tractor	(5,514)
Gain realized but not recognized	$ 4,486

Combine for Corn Planter

The gain Rachel realizes on the exchange of the combine for the corn planter is shown in Figure 16.7. The trade qualifies as a like-kind exchange because the combine and corn planter are both included in NAICS Product Class 333111, "Farm Machinery and Equipment Manufacturing." However, Rachel must recognize gain to the extent that she received boot ($15,000 cash). Therefore, she must recognize $15,000 of gain and roll the remaining $558 of gain into the planter.

The $15,000 recognized gain is all ordinary income under the I.R.C. § 1245 recapture rules because Rachel had claimed $32,558 of depreciation on the combine.

Figure 16.7 Realized Gain on Combine

Trade-in value of combine	$40,000
Adjusted basis of combine	(24,442)
Gain realized	$15,558

2001 Car for 2011 Car

Because the old and new cars are used partially for business and partially for personal use, the trade must be treated as if each car is two separate assets—a business asset and a personal-use asset. The car's $4,000 FMV is divided between the business and personal assets.

The gain Rachel realizes on the business portion is shown in Figure 16.8. The trade qualifies as a like-kind exchange, so Rachel does not have to report that $2,000 of gain.

Figure 16.8 Deferred Gain on Business-Use Car

Trade-in value of one-half	$2,000
Adjusted basis of business one-half	(0)
Gain realized but not recognized	$2,000

The $5,000 loss Rachel realizes on the personal-use portion is shown in Figure 16.9. This is not a like-kind exchange because the property was not held for use in a trade or business or for investment, but Rachel cannot recognize her loss because it was realized on a personal-use asset.

Figure 16.9 Nondeductible Loss on Personal Car

Trade-in value of one-half	$ 2,000
Adjusted basis of personal-use one-half	(7,000)
Loss realized but not recognized	$(5,000)

Reporting Like-Kind Exchanges

The tax-free exchange treatment of I.R.C. § 1031 is **not** elective. If an exchange meets the requirements, the taxpayer must postpone including the realized gain or loss in income (except for gain or loss on an exchange of boot), using the deferred gain or loss to adjust the basis of the property received.

Like-kind exchanges must be reported on a Form 8824, Like-Kind Exchanges (and section 1043 conflict-of-interest sales), that is filed with the taxpayer's income tax return for the year of the exchange.

Practitioner Note Related-Party Exchanges

If property is transferred in a like-kind exchange to a related party, Form 8824 must also be filed for the 2 years following the year of the transfer to report that neither the property acquired nor the property relinquished had been transferred again, or to report the gain that is triggered if there is a subsequent transfer during the 2-year period. See Issue 2 of the "Business Issues" chapter in this book for an example of this rule.

If more than one exchange occurs during a tax year, a summary Form 8824 may be filed with an attached statement showing all the information for each exchange. When a summary statement is used, only the totals for lines 23 and 25, plus the entity information, are included on Form 8824. "Summary" is entered on line 1 of Form 8824.

The summary statement for the transactions in Example 16.14 is shown in Figure 16.10.

Figure 16.10 Reporting on Rachel Brown's 2011 Form 8824

Form 8824 Line Number and Description	Old Tractor for New Tractor	Combine for Corn Planter	2001 Car for 2011 Car (Business Portions)
15. Cash and FMV of unlike property received	$ 0	$15,000	$ 0
16. FMV of like-kind property received	60,000	25,000	10,000
17. Add lines 15 and 16	$60,000	$40,000	$10,000
18. Adjusted basis of relinquished property and and net amounts paid	55,514	24,442	8,000
19. Realized gain or (loss) (subtract line 18 from line 17)	$ 4,486	$15,558	$ 2,000
20. Smaller of line 15 or line 19	$ 0	$15,000	$ 0
21. Recapture income	0	15,000	0
22. Subtract line 21 from line 20	$ 0	$ 0	$ 0
23. Recognized gain (add lines 21 and 22)	$ 0	$15,000	$ 0
24. Deferred gain or (loss) (subtract line 23 from line 19)	$ 4,486	$ 558	$ 2,000
25. Basis of property received (subtract line 15 from the sum of lines 18 and 23)	$ 5,514	$24,442	$ 8,000

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Practitioner Note Depreciation of Replacement Property

Treas. Reg. § 1.168(i)-6 sets out the rules for depreciating property that is acquired in a like-kind exchange. In general, those rules require taxpayers to depreciate the basis carried over from the relinquished property (the exchanged basis) over the longer of the remaining recovery period of the relinquished property or the remainder of the recovery period for the replacement property if it had been placed in service on the date the relinquished property was placed in service. The depreciation method for the exchanged basis is the slower of the method used for the relinquished property and the method allowable for the acquired property.

In general, the regulations require the excess basis (the amount paid for the replacement property in excess of the value of the relinquished property) to be depreciated over the replacement property's recovery period using a method allowed for the replacement property.

However, Treas. Reg. § 1.168(i)-6(i)(1) allows taxpayers to elect to depreciate the entire basis of the replacement property over the replacement property's recovery period using a method that is allowed for the replacement property.

Subsequent Sale of Received Property

Gain that is postponed in a like-kind exchange is recognized on the later sale of the asset received in the like-kind exchange. If potential depreciation recapture was included in the postponed gain, that recapture is recognized in the sale of the assets that were received in the like-kind exchange.

Example 16.15 Subsequent Sale

Rachel Brown, from Example 16.14, used the corn planter in 2011–2013 and then sold it for $26,000. Her gain is $19,017, as shown in Figure 16.11.

Figure 16.11 Rachel Brown's Gain on Sale of Corn Planter

Amount realized		$26,000
Less adjusted basis		
Unadjusted basis	$24,442	
Depreciation	17,459	
Adjusted basis		(6,983)
Gain realized		$19,017

Rachel must report $18,017 of the realized gain as ordinary income from I.R.C. § 1245 recapture, as shown in Figure 16.12. She claimed $17,459 of depreciation on the planter, but the $558 of I.R.C. § 1245 gain that she rolled over from the combine is also recognized when she sells the corn planter. This $558 would have been reported as depreciation recapture in 2011 if the gain on the combine had been recognized then.

The Form 4797 instructions for line 22, "Depreciation (or depletion) allowed or allowable," tell the taxpayer to include the depreciation claimed on the relinquished property in the depreciation listed for the replacement property that is currently being sold. However, the includable depreciation from the transferred asset is limited to the gain that was rolled over into the asset acquired. In this case, that is $558. Therefore, the depreciation reported on line 22 of Rachel's Form 4797 is the $18,017 total shown in Figure 16.12.

Figure 16.12 Inclusion of Prior Depreciation

Depreciation on planter	$17,459
Deferred I.R.C. § 1245 gain from combine	558
Total	$18,017

Rachel also increases the basis she reports on line 21 of Form 4797 by the $558 gain that was rolled into the planter. [See the IRS instructions for line 22 of Form 4797 and Treas. Reg. § 1.1245-2(c)(4).] That adjustment is necessary to arrive at the appropriate gain on line 24 of Form 4797. See Figure 16.13. (Note: The 2011 draft version of Form 4797 is shown because the 2013 Form 4797 is not available.)

Figure 16.13 Rachel Brown's 2013 Form 4797

Form **4797**

Department of the Treasury
Internal Revenue Service (99)

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

► **Attach to your tax return.** ► **See separate instructions.**

OMB No. 1545-0184

201~~1~~3

Attachment Sequence No. **27**

Name(s) shown on return	Identifying number
Rachel Brown	882-41-1031

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255 (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Corn planter	03/10/2011	06/20/2013
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ►		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	26,000			
21 Cost or other basis plus expense of sale	21	25,000			
22 Depreciation (or depletion) allowed or allowable	22	18,017			
23 Adjusted basis. Subtract line 22 from line 21	23	6,983			
24 Total gain. Subtract line 23 from line 20	24	19,017			
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a	18,017			
b Enter the **smaller** of line 24 or 25a	25b	18,017			

Draft as of 8/01/2011

Tax Planning

The gain realized on the sale of machinery is not subject to the self-employment (SE) tax, whereas depreciation claimed on the asset received in a like-kind exchange reduces SE income. Consequently, it is often to the taxpayer's advantage to sell an asset and recognize the gain, rather than to carry out a like-kind exchange, in order to obtain a higher depreciable basis in the new asset.

Planning Pointer Sales Tax Should Be Considered

If state law requires taxpayers to pay sales tax on the net purchase price of the acquired asset, then an outright sale of the relinquished property followed by an outright purchase of the acquired property causes the taxpayer to pay more sales tax than would be due on the boot in a like-kind exchange.

Example 16.16 Recognizing Gain

If Rachel Brown, from Example 16.14, sold the old tractor for $10,000 and paid $60,000 for the new tractor, she will report the $4,486 gain shown in Figure 16.6 as ordinary income (I.R.C. § 1245 recapture) that is not subject to the SE tax on her 2011 return. Her basis in the new tractor will be its $60,000 purchase price, unreduced by her $4,486 gain.

If Rachel makes an I.R.C. § 179 election for the additional $4,486 of basis in the new tractor, she will reduce her taxable income by $4,486 for both income tax and SE tax purposes. The income tax deduction will offset the $4,486 gain from the sale of the relinquished tractor, and the SE tax deduction will save $551 of SE tax ($4,486 × 0.9235 × 0.133 = $551). Her income tax deduction for SE tax will decrease by $317 (0.5751 × $551), which increases her taxable income by $317.

Cross-Reference 2011 SE Income Tax Deduction

See the "New Legislation" chapter in this book for an example of the 2011 Schedule SE (Form 1040) and an explanation of the 57.51% rate that applies to the SE income tax deduction for 2011.

If Rachel is subject to a 5% sales tax on the net purchase price of the acquired tractor, the outright sale and separate purchase will increase her sales tax by $224 ($4,486 × 5%). The sales tax is not a current deduction, but it increases her depreciable basis in the tractor.

Planning Pointer Avoiding Treatment as Like-Kind Exchange

If a taxpayer wants to recognize gain or loss on disposition of old machinery, the transaction must be structured to avoid triggering the like-kind exchange rules. Because like-kind exchange treatment is not elective, the gain or loss will be rolled over and the basis in the replacement property will be adjusted if the transaction qualifies as a like-kind exchange.

Example 16.17 Attempt to Avoid Like-Kind Exchange

Clarence Potter owns an old tractor that is worth $10,000 and is fully depreciated. It is tax-wise for him to sell the old tractor and buy a new tractor outright rather than to trade the old tractor for a new one. The implement dealer agreed to buy his old tractor and write Clarence a check, if Clarence agrees to buy the new tractor from the same dealer and write out his check for the purchase price.

Question.
Is this a sale and purchase or a trade?

Answer.
This transaction is a trade. Rev. Rul. 61-119, 1961-1 C.B. 395, has identical facts. The IRS stated that this was a nontaxable like-kind exchange even though the dealer and the taxpayer had separate contracts and both treated the transactions separately in their respective books and records. If the transactions are mutually dependent on each other, the IRS views the two transactions as steps in a single related and dependent transaction.

Practitioner Note Substance over Form Doctrine

This issue has been litigated. Both the IRS and the courts have placed great reliance on the *substance over form* doctrine when dealing with this situation. If the sale and purchase are clearly separate, unrelated, and independent of each other, then Rev. Rul. 61-119 does not apply.

Example 16.18 Independent Transactions

Joe Hinz sold his old tractor to an implement dealer on February 26, 2011, for $10,000 to obtain cash to pay his income tax. The implement dealer regularly buys old farm implements from farmers to sell at its semiannual auction sales in March and October. On March 14, 2011, Joe bought a new planter from the same implement dealer for $18,000, because Joe's new landlord expressed concern that Joe's old planter was inadequate.

In this example, the sale of the tractor and the purchase of the planter are separate and independent transactions, even though the equipment is like kind. See *C. Bean Lumber Transport, Inc. v. United States,* 68 F.Supp.2d 1055 (W.D. Ark. 1999) for an analysis of this issue.

ISSUE 5: LIKE-KIND EXCHANGE OF LIVESTOCK

Farmers who are retiring from dairy farming may want to postpone recognizing gain from the sale of their dairy herd by exchanging it for a beef herd, which requires less care.

If livestock are the same sex, can they qualify as like-kind property? As discussed in Issue 4 of the chapter, *like kind* is interpreted more narrowly for personal property than it is for real property. The safe harbors for like-class property in the regulations can be used by taxpayers to show that replacement property is like kind, but they cannot be used by the IRS to show that it is not like kind. Properties that are outside the safe harbors can still be like kind.

Because livestock is included in NAICS sector 11, it is **not** within the Treas. Reg. § 1.1031(a)-2(b)(3) safe harbor, which includes only sectors 31, 32, and 33. But that does not mean that livestock cannot qualify for like-kind treatment. Omission from the safe harbors simply means that taxpayers must rely on prior case law and rulings to show that an exchange of livestock is a like-kind exchange.

Dairy Cows for Beef Cows

There is very little guidance in court cases on whether an exchange of dairy cows for beef cows is a like-kind exchange. I.R.C. § 1031(e) says livestock of different sexes are not property of a like-kind, but this does not preclude treating an exchange of a dairy cow for a beef cow as a like-kind exchange.

Treas. Reg. § 1.1031(a)-1(b) states, "As used in section 1031(a), the words 'like kind' have reference to the nature or character of the property and not to its grade or quality." Therefore, the fact that a dairy cow is a different grade or quality than a beef cow does not preclude them from being like kind.

If sector 11 were included in the safe harbor, an exchange of a dairy cow or heifer for a beef cow or heifer would be a like-kind exchange, because NAICS Product Class 112111, "Beef Cattle Ranching and Farming," includes all aspects of raising and feeding beef cattle as well as dairy heifer replacement production. Consequently, raising beef heifers and raising dairy heifers (which is the only way to produce cows) are in the same 6-digit product class.

Livestock Held for Breeding

In *Leo v. Woodbury,* 49 T.C. 180 (1967), the court carefully examined an exchange of cattle and held that the exchange of yearlings that were held for *sale* did not qualify for like-kind exchange treatment because I.R.C. § 1031 excludes exchanges of "stock in trade or other property held primarily for sale." Without analyzing the breed or age of the cows held for *breeding*, the court held that they were like kind.

In *Rutherford v. Commissioner*, T.C. Memo. 1978-505, the court imposed like-kind treatment on a taxpayer who received half-blood heifers in exchange for a promise to breed them and return the first three-quarter-blood heifers that were born by them to the other party. Again there was no discussion of whether the heifers were dairy or beef animals. The fact that half-blood animals were exchanged for three-quarter-blood animals did not preclude them from being like kind.

As a practical matter, if the IRS argues that a dairy cow and a beef cow are not like kind, it will have a difficult time defining the boundaries of that rule. Some breeds of cattle are used for both dairy and beef production. Are they like kind to both dairy and beef cattle or to neither?

Conclusion

Because livestock is not included in the safe harbors for like-kind exchanges of personal property, taxpayers must rely on the Internal Revenue Code, other regulations, cases, and rulings. Without clear authority supporting or opposing like-kind treatment of dairy and beef cows, taxpayers can take the position that they are like kind, but they should be aware that there is little ammunition to defend that position other than the argument that a cow is a cow.

ISSUE 6: CASUALTY LOSS TO FARM

This issue illustrates the tax deductions that are available from a farm flood loss.

The "Casualty Gains and Losses" chapter in this book explains the general tax rules that apply to gains and losses realized from casualties such as tornadoes, hail storms, and floods. This issue applies those rules to a farm case study of flooding along the Missouri River.

Facts for Case Study

In June 2011, flooding from the Missouri River covered Hector and Maria Sanchez's farmstead and 1,000 acres of growing crops. The land did not dry out until late in the fall of 2011. Hector and Maria estimate that it will cost $120,000 to remove silt and trash to restore the land to a condition that is suitable for production. It is doubtful the land can be cleared and restored in time for planting a crop in 2012.

Hector and Maria had insurance on the growing crops, their home, and the outbuildings. Fortunately, they had enough warning to remove their machinery, stored grain, and many personal assets prior to the flooding. They did not have time to move some equipment that had been fully depreciated and was in a storage shed that had been purchased less than a year before the flood.

They sold the corn they had stored at the farm for a seasonal high price of $7.20 per bushel. Not including insurance payments and land restoration expenses, Hector and Maria had $750,000 of gross receipts from commodity sales, $400,000 of crop expenses, and $25,000 of depreciation on assets purchased in prior years. They did not purchase any depreciable assets in 2011.

Figure 16.14 reports the tax basis, pre-flood FMV, insurance payment, and cost of restoring the assets that were damaged or destroyed by the flooding.

Figure 16.14 Assets Damaged or Destroyed by Flooding

Asset	Tax Basis	FMV before Flood	Insurance Payment	Estimated Cost to Restore
Cropland	$500,000	$7,000,000	$ 0	$ 120,000
2011 crops	0	93,000	650,000	930,000
Home	55,000	150,000	150,000	200,000
Grain bins	15,000	100,000	50,000	30,000
Storage shed	29,250	60,000	45,000	25,000
Shed contents	0	50,000	50,000	65,000
Total	$599,250	$7,453,000	$945,000	$1,370,000

Reporting Gains and Losses

Hector and Maria must use Form 4684, Casualties and Thefts; Form 4797, Sales of Business Property; Schedule D (Form 1040), Capital Gains and Losses; and Form 8949, Sales and Other Dispositions of Capital Assets, to report their casualty gains and losses.

Home

Hector and Maria realized a $95,000 gain on their home ($150,000 insurance – $55,000 basis), which they must report in Section A of Form 4684 (Figure 16.15) as a personal casualty gain. The gain is carried to line 11 of Schedule D (Form 1040) (Figure 16.17). Because I.R.C. § 121 excludes the gain from the Sanchez's income, they enter a negative $95,000 on line 3 of Form 8949 (Figure 16.18). The negative $95,000 is carried to line 8 of Schedule D (Form 1040), where it offsets the $95,000 gain reported on line 11.

Cropland

A measure of the damage to the cropland is the $120,000 cost of restoring it. Therefore, Hector and Maria report the $7,000,000 FMV of their land on line 23 in Section B of Form 4684 (Figure 16.15), $6,880,000 on line 24, and the $120,000 difference on line 25. Their loss is limited to the lesser of the $120,000 decrease in value or their $500,000 basis reported on line 20. If they had received any insurance payment to compensate for their loss (line 21), the deductible loss would be reduced by that payment.

Because the $120,000 casualty loss from property held more than a year is an ordinary loss, it is netted with the $15,750 short-term gain from the storage shed. The $104,250 ($120,000 – $15,750) net loss is then reported on line 14 of Form 4797 (Figure 16.16).

Grain Bins

The basis, insurance payment, and gain on the grain bins are reported on lines 20, 21, and 22 of Form 4684 (Figure 16.15). Because the grain bins are I.R.C. § 1245 property [I.R.C. § 1245(a)(3)(B)(iii)], their deemed sale to the insurance company must be reported in Part III of Form 4797 (Figure 16.16). Because all of the $35,000 gain ($50,000 insurance payment – $15,000 basis) from the grain bins is recaptured under I.R.C. § 1245, none of it is reported on line 33 of Form 4684 to be netted with other casualty and theft gains and losses from property held more than 1 year.

Storage Shed

The basis, insurance payment, and gain on the storage shed are also reported on lines 20, 21, and 22 of Form 4684 (Figure 16.15). Because the grain bins were held less than a year, the $15,750 gain ($45,000 insurance payment – $29,250 basis) is reported on line 29 of Form 4684 and is netted with the $120,000 loss from the cropland. The $104,250 net loss is reported on line 14 of Form 4797 (Figure 16.16).

Equipment

The zero basis, $40,000 insurance payment, and $40,000 gain on the equipment are also reported on lines 20, 21, and 22 of Form 4684 (Figure 16.15). Because the equipment is subject to I.R.C. § 1245 recapture, its deemed sale to the insurance company must be reported in Part III of Form 4797 (Figure 16.16). Because all of the gain from the equipment is recaptured under I.R.C. § 1245, none of it is reported on line 33 of Form 4684 to be netted with other casualty and theft gains and losses from property held more than 1 year.

Figure 16.15 Hector and Maria Sanchez's Form 4684 (Page 1 of 2)

Form **4684** Department of the Treasury Internal Revenue Service

Casualties and Thefts

▶ See separate instructions.
▶ Attach to your tax return.
▶ Use a separate Form 4684 for each casualty or theft.

OMB No. 1545-0177
2011
Attachment Sequence No. 26

Name(s) shown on tax return	Identifying number
Hector and Maria Sanchez	165-01-4684

SECTION A—Personal Use Property (Use this section to report casualties and thefts of property **not** used in a trade or business or for income-producing purposes.)

1 Description of properties (show type, location, and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft.

Property **A** Home (purchased 09/26/1978); flooding 06/20/2011; 65089 Dallas Road, Rural, Iowa 55555
Property **B**
Property **C**
Property **D**

			Properties A	B	C	D
2	Cost or other basis of each property	2	55,000			
3	Insurance or other reimbursement (whether or not you filed a claim) (see instructions)	3	150,000			
	Note: *If line 2 is* ***more*** *than line 3, skip line 4.*					
4	Gain from casualty or theft. If line 3 is **more** than line 2, enter the difference here and skip lines 5 through 9 for that column. See instructions if line 3 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year	4	95,000			
5	Fair market value **before** casualty or theft	5				
6	Fair market value **after** casualty or theft	6				
7	Subtract line 6 from line 5	7				
8	Enter the **smaller** of line 2 or line 7	8				
9	Subtract line 3 from line 8. If zero or less, enter -0-	9				

10	Casualty or theft loss. Add the amounts on line 9 in columns A through D	10	
11	Enter the **smaller** of line 10 or $100	11	
12	Subtract line 11 from line 10	12	
	Caution: *Use only one Form 4684 for lines 13 through 18.*		
13	Add the amounts on line 12 of all Forms 4684	13	
14	Add the amounts on line 4 of all Forms 4684.	14	95,000
15	• If line 14 is **more** than line 13, enter the difference here and on Schedule D. **Do not** complete the rest of this section (see instructions). • If line 14 is **less** than line 13, enter -0- here and go to line 16. • If line 14 is **equal** to line 13, enter -0- here. **Do not** complete the rest of this section.	15	95,000
16	If line 14 is **less** than line 13, enter the difference	16	To line 11 of Schedule D (Form 1040) (Figure 16.17)
17	Enter 10% of your adjusted gross income from Form 1040, line 38, or Form 1040NR, line 37. Estates and trusts, see instructions	17	
18	Subtract line 17 from line 16. If zero or less, enter -0-. Also enter the result on Schedule A (Form 1040), line 20, or Form 1040NR, Schedule A, line 6. Estates and trusts, enter the result on the "Other deductions" line of your tax return	18	

For Paperwork Reduction Act Notice, see instructions. Cat. No. 12997O Form **4684** (2011)

Draft as of 06/30/2011

Figure 16.15 (continued) Hector and Maria Sanchez's Form 4684 (Page 2 of 2)

Form 4684 (2011) Attachment Sequence No. **26** Page **2**

Name(s) shown on tax return. Do not enter name and identifying number if shown on other side. | **Identifying number**

Draft as of 06/30/2011

SECTION B—Business and Income-Producing Property

Part I Casualty or Theft Gain or Loss (Use a separate Part I for each casualty or theft.)

19 Description of properties (show type, location, and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft.

Property **A** 1,000 acres of crop land (various acquisition dates); flooding June 20, 2011; Washington township, Lincoln County, Iowa;

Property **B** Grain bins (various purchase dates); flooding June 20, 2011; 65089 Dallas Road, Rural Iowa, 55555

Property **C** Storage shed (purchased August 18, 2010); flooding June 20, 2011; 65089 Dallas Road, Rural Iowa, 55555

Property **D** Equipment (various purchase dates); flooding June 20, 2011; 65089 Dallas Road, Rural Iowa, 55555

		Properties			
		A	**B**	**C**	**D**
20 Cost or adjusted basis of each property	**20**	500,000	15,000	29,250	0
21 Insurance or other reimbursement (whether or not you filed a claim). See the instructions for line 3	**21**	0	50,000	45,000	40,000
Note: *If line 20 is* ***more*** *than line 21, skip line 22.*					
22 Gain from casualty or theft. If line 21 is **more** than line 20, enter the difference here and on line 29 or line 34, column (c), except as provided in the instructions for line 33. Also, skip lines 23 through 27 for that column. See the instructions for line 4 if line 21 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year	**22**	0	35,000	15,750	40,000
23 Fair market value **before** casualty or theft	**23**	7,000,000			
24 Fair market value **after** casualty or theft	**24**	6,880,000			
25 Subtract line 24 from line 23	**25**	120,000			
26 Enter the **smaller** of line 20 or line 25	**26**	120,000			
Note: *If the property was totally destroyed by casualty or lost from theft, enter on line 26 the amount from line 20.*					
27 Subtract line 21 from line 26. If zero or less, enter -0-	**27**	120,000			

28 Casualty or theft loss. Add the amounts on line 27. Enter the total here and on line 29 **or** line 34 (see instructions) **28** 120,000

Part II Summary of Gains and Losses (from separate Parts I)

(a) Identify casualty or theft		(b) Losses from casualties or thefts: (i) Trade, business, rental or royalty property	(b) (ii) Income-producing and employee property	(c) Gains from casualties or thefts includible in income
Casualty or Theft of Property Held One Year or Less				
29 Storage shed		( )	( )	15,750
		( )	( )	
30 Totals. Add the amounts on line 29	**30**	( )	( )	15,750
31 Combine line 30, columns (b)(i) and (c). Enter the net gain or (loss) here and on Form 4797, line 14. If Form 4797 is not otherwise required, see instructions	**31**			15,750
32 Enter the amount from line 30, column (b)(ii) here. Individuals, enter the amount from income-producing property on Schedule A (Form 1040), line 28, or Form 1040NR, Schedule A, line 14, and enter the amount from property used as an employee on Schedule A (Form 1040), line 23, or Form 1040NR, Schedule A, line 9. Estates and trusts, partnerships, and S corporations, see instructions	**32**			To line 14 of Form 4797 (Figure 16.16)
Casualty or Theft of Property Held More Than One Year				
33 Casualty or theft gains from Form 4797, line 32	**33**			0
34 1,000 acres of cropland		(120,000)	( )	
		( )	( )	
35 Total losses. Add amounts on line 34, columns (b)(i) and (b)(ii)	**35**	(120,000)	( )	
36 Total gains. Add lines 33 and 34, column (c)	**36**			
37 Add amounts on line 35, columns (b)(i) and (b)(ii)	**37**			-120,000
38 If the loss on line 37 is **more** than the gain on line 36:				
a Combine line 35, column (b)(i) and line 36, and enter the net gain or (loss) here. Partnerships (except electing large partnerships) and S corporations, see the note below. All others, enter this amount on Form 4797, line 14. If Form 4797 is not otherwise required, see instructions	**38a**			-120,000
b Enter the amount from line 35, column (b)(ii) here. Individuals, enter the amount from income-producing property on Schedule A (Form 1040), line 28, or Form 1040NR, Schedule A, line 14, and enter the amount from property used as an employee on Schedule A (Form 1040), line 23, or Form 1040NR, Schedule A, line 9. Estates and trusts, enter on the "Other deductions" line of your tax return. Partnerships (except electing large partnerships) and S corporations, see the note below. Electing large partnerships, enter on Form 1065-B, Part II, line 11	**38b**			To line 14 of Form 4797 (Figure 16.16)
39 If the loss on line 37 is **less** than or **equal** to the gain on line 36, combine lines 36 and 37 and enter here. Partnerships (except electing large partnerships), see the note below. All others, enter this amount on Form 4797, line 3	**39**			

Note: *Partnerships, enter the amount from line 38a, 38b, or line 39 on Form 1065, Schedule K, line 11. S corporations, enter the amount from line 38a or 38b on Form 1120S, Schedule K, line 10.*

Form **4684** (2011)

Figure 16.16 Exerpts from Hector Sanchez's Form 4797

Form **4797**

Department of the Treasury
Internal Revenue Service (99)

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ Attach to your tax return. ▶ See separate instructions.

OMB No. 1545-0184

2011

Attachment Sequence No. 27

Name(s) shown on return	Identifying number
Hector Sanchez	165-01-4684

Part II Ordinary Gains and Losses (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	75,000
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	-104,250
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	-29,250
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 28, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 23. Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14	18b	-29,250

$15,750 from line 31 of Form 4684 (Figure 16.15 minus $120,000 from line 38a of Form 4684 (Figure 16.15)

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (2011)

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255 (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Grain bins 65089 Dallas Road, Rural Iowa, 55555	various	06/20/2011
B Equipment	various	06/20/2011
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	50,000	40,000		
21 Cost or other basis plus expense of sale	21	90,000	55,000		
22 Depreciation (or depletion) allowed or allowable	22	75,000	55,000		
23 Adjusted basis. Subtract line 22 from line 21	23	15,000	0		
24 Total gain. Subtract line 23 from line 20	24	35,000	40,000		
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a	75,000	55,000		
b Enter the **smaller** of line 24 or 25a	25b	35,000	40,000		

Draft as of 08/01/2011

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30	Total gains for all properties. Add property columns A through D, line 24	30	75,000
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	75,000
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	0

16

Figure 16.17 Hector and Maria Sanchez's Schedule D (Form 1040)

SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040 or Form 1040NR. ▶ See Instructions for Schedule D (Form 1040).
▶ Use Form 8949 to list your transactions for lines 1, 2, 3, 8, 9, and 10.

OMB No. 1545-0074

2011

Attachment Sequence No. 12

Name(s) shown on return	Your social security number
Hector and Maria Sanchez	165-01-4684

Draft as of 04/21/2011

Part I **Short-Term Capital Gains and Losses—Assets Held One Year or Less**

Note: Please round and use whole dollars on this form.	**(e)** Sales price from Form(s) 8949, line 2, column (e)	**(f)** Cost or other basis from Form(s) 8949, line 2, column (f)	**(g)** Adjustments to gain or loss from Form(s) 8949, line 2, column (g)	**(h) Gain or (loss)** Combine columns (e), (f), and (g)
1 Short-term totals from all Forms 8949 with box A checked in Part I		( )		
2 Short-term totals from all Forms 8949 with box B checked in Part I		( )		
3 Short-term totals from all Forms 8949 with box C checked in Part I		( )		

4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824	4	
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	5	
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your **Capital Loss Carryover Worksheet** in the instructions	6	( )
7 **Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (h)	7	

Part II **Long-Term Capital Gains and Losses—Assets Held More Than One Year**

Note: Please round and use whole dollars on this form.	**(e)** Sales price from Form(s) 8949, line 4, column (e)	**(f)** Cost or other basis from Form(s) 8949, line 4, column (f)	**(g)** Adjustments to gain or loss from Form(s) 8949, line 4, column (g)	**(h) Gain or (loss)** Combine columns (e), (f), and (g)
8 Long-term totals from all Forms 8949 with box A checked in Part II		( )		-95,000
9 Long-term totals from all Forms 8949 with box B checked in Part II		( )		
10 Long-term totals from all Forms 8949 with box C checked in Part II		( )		

From line 4 of Form 8949 (Figure 16.18)

11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11	95,000
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12	
13 Capital gain distributions. See the instructions	13	
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your **Capital Loss Carryover Worksheet** in the instructions	14	( )
15 **Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (h). Then go to Part III on the back	15	0

From line 15 of Form 4684 (Figure 16.15)

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11338H **Schedule D (Form 1040) 2011**

Figure 16.18 Hector and Maria Sanchez's Form 8949, Part II

Form 8949 (2011) Attachment Sequence No. **12A** Page **2**

Name(s) shown on return. Do not enter name and social security number if shown on other side.	**Your social security number**
Hector and Maria Sanchez	**165-01-4684**

Part II **Long-Term Capital Gains and Losses—Assets Held More Than One Year**

Note. Please round and use whole dollars on this form.
Check the box below that describes the transactions listed on this page.
Caution. Check only one box. If you have more than one type of transaction, complete a separate Form 8949 for each type.

☐ **(A)** Long-term gains and losses (Form 1099-B, box 3, shows basis)
☐ **(B)** Long-term gains and losses (Form 1099-B, box 3, does not show basis)
☑ **(C)** Long-term gains and losses (Form 1099-B not received)

3 **(a)** Description of property (Example: 100 sh. XYZ Co.)	**(b)** Code	**(c)** Date acquired (Mo., day, yr.)	**(d)** Date sold (Mo., day, yr.)	**(e)** Sales price (see instructions)	**(f)** Cost or other basis (see instructions)	**(g)** Adjustments to gain or loss
Gain on home excluded under IRC § 121		**09/26/1978**	**06/20/2011**			**-95,000**
4 **Totals.** Add the amounts in columns (e) and (f). Also, combine the amounts in column (g). Enter here and include on Schedule D, line 8 (if box A above is checked), line 9 (if box B above is checked), or line 10 (if box C above is checked) . . . . ▶ 4					To line 8 of Schedule D (Form 1040) (Figure 16.17)	**-95,000**

Form **8949** (2011)

ISSUE 7: FERTILIZER OR NUTRIENTS ACQUIRED WITH LAND

Some buyers of farmland are allocating part of their purchase price to fertilizer that was applied to the land before the purchase. This issue reviews the tax rules that require buyers and sellers to allocate the purchase price of a group of assets and applies those rules to fertilizer acquired with farmland.

Tax law requires the purchase price of a group of assets to be allocated among the assets. When improved land is purchased, the price must be divided between the land and the various assets that are purchased with the land, such as fences, wells, roads, buildings, and timber.

With the increases in the price of farmland and the cost of fertilizer, some buyers are allocating part of the purchase price of the land to fertilizer that was applied to the land before the purchase. Similarly, some taxpayers are allocating part of the date-of-death fair market value (FMV) of farmland to fertilizer that was applied to the land before the decedent's death. That allocation lets them amortize and deduct the basis allocated to the fertilizer instead of including that portion of the basis in the nondepreciable basis of the land.

Practitioner Note Land Acquired by Gift

Taxpayers who acquire land by gift cannot argue that part of the value of the gift is allocated to the basis of the fertilizer purchased with the land because the donee's basis in assets is a carryover basis from the donor. Because the donor deducted the cost of the fertilizer in most cases, the donor's basis in the fertilizer is zero, and that zero basis carries over to the donee.

Background

As background for the discussion of allocating purchase price to land, this section summarizes the rules for determining the basis of assets, allocating the purchase price of a group of assets, and deducting the cost of fertilizer.

Basis of Assets

A taxpayer's beginning (unadjusted) income tax basis in an asset is determined by one or more of several rules. The unadjusted basis of a purchased asset is the asset's cost [I.R.C. § 1012(a)]. The unadjusted basis of an inherited asset is generally the asset's FMV on the decedent's date of death or the estate tax alternate valuation date [I.R.C. § 1014(a)]. The unadjusted basis of an asset acquired by gift is generally the donor's basis in the asset [I.R.C. § 1015(a)]. If a taxpayer acquires an asset in a transaction that defers recognition of gain, the beginning basis is in whole or in part transferred from another asset. Examples of those transactions include like-kind exchanges [I.R.C. § 1031(d)], involuntary conversions [I.R.C. § 1033(b)], tax-free incorporations [I.R.C. §§ 358 and 362], and contributions of property to a partnership [I.R.C. §§ 722 and 723].

Cost Allocation Rules

I.R.C. § 1060 requires taxpayers who buy a group of assets that constitute a trade or business to use a residual method to allocate the purchase price among the assets. Treas. Reg. § 1.1060-1(b)(2)(i) says a group of assets constitutes a trade or business if the use of such assets constitutes a trade or business, or if goodwill or going-concern value could attach to the group of assets. Sellers must follow the same allocation rules to report their gain or loss on the sale of a group of assets that constitutes a trade or business.

Cross-Reference Example Included in "Business Entities"

See Issue 4 in the "Business Entities" chapter of this book for an illustration of the I.R.C. § 1060 rules to a business that is sold for less than the FMV of its assets.

Asset Classes

IRS Form 8594, Asset Acquisition Statement Under Section 1060, lists the following seven classes of assets that are identified in Treas. Reg. § 1.338-6(b):

Class I

- Cash
- General deposit accounts (including savings and checking accounts, but excluding certificates of deposit)

Class II

- Certificates of deposit
- U.S. government securities
- Foreign currency
- Personal property such as stock and securities that is actively traded (this means that an established financial market exists for it)

Class III

- Accounts receivable
- Other debt instruments, excluding related-party debt instruments, contingent debt instruments, and debt instruments that are convertible into stock or other property
- Assets that are marked-to-market annually for federal income tax purposes

Class IV

- Property properly includable in inventory
- Property held primarily for sale to customers in the ordinary course of business

Class V

- Furniture and fixtures
- Equipment that is part of the business
- Buildings and land
- Vehicles
- Any other assets that are not included in any of the other six classes

Class VI

- Workforce in place
- Books and records, operating systems, and other information bases
- Patents, copyrights, formulas, processes, designs, know-how, format, and similar items
- Customer-based intangibles
- Supplier-based intangibles
- Licenses, permits, and other rights granted by a government agency

- Covenants not to compete
- Franchises, trademarks, and trade names
- Any other I.R.C. § 197 intangibles other than goodwill and going-concern value

Class VII

- Goodwill (reputation and good standing)
- Going-concern value (the ability to conduct business in the future)

The purchase price is allocated first to assets in Class I to the extent of the FMV of the assets in that class. The remaining purchase price is then allocated to the assets in Class II to the extent of the FMV of the assets in that class. This process is repeated until the remaining purchase price is less than the sum of the FMVs of the assets in the next class. At that point, the remaining purchase price is allocated pro rata among the assets in that class using the ratio of their individual FMVs to the total FMV of all assets in the class. If a portion of the purchase price remains after the price has been allocated to all assets in Class VI, the remainder is allocated to assets in Class VII.

Sales of Farmland

Most sales of farmland are not subject to the I.R.C. § 1060 allocation rules because farmland generally is not purchased with a group of assets that constitutes a trade or business or includes goodwill. If I.R.C. § 1060 does not apply to a transaction, the buyer and seller do not have to file Form 8594 to report an allocation of the purchase price. However, the buyer still must allocate the purchase price to determine basis in the land and each depreciable improvement [Treas. Reg. § 1.167(a)-5], and the seller must allocate the purchase price to determine gain on the land and each improvement [I.R.C. § 1.61-6(a)]. The parties could choose to use the residual method of allocating the purchase price even if I.R.C. § 1060 does not require them to use it.

If the parties to a transaction have adverse interests, deal at arm's length, and agree to an allocation of the purchase price, courts generally will honor that allocation if there is no reason to question the bona fides of the transaction [*Black Industries, Inc. v. Commissioner,* T.C. Memo. 1979-61]. IRS Publication 225, *Farmer's Tax Guide* (2010), at page 31, states that the IRS generally will accept an allocation that is agreed upon by a buyer and a seller if it is based on the value of each asset and the buyer and seller have adverse tax interests.

In most cases, unrelated buyers and sellers have adverse interests because the buyer wants to allocate as much of the purchase price as possible to depreciable or deductible assets. The seller wants to allocate as little of the selling price as possible to those assets because gain on those assets is generally taxed as ordinary income. The seller wants to allocate as much as possible to the land, because long-term gain on land is taxed at lower rates, whereas the buyer wants to allocate as little as possible to the land because basis in land cannot be depreciated.

Example 16.19 Allocation of Purchase Price

Hominy Gritts paid $80,000 to buy farmland from an unrelated party. Neither Hominy nor the seller is required to file Form 8594 or use the residual method for allocating the price because the farm property is not a trade or business. As shown in Figure 16.19, the total FMV of the land and improvements is $100,000.

Figure 16.19 Allocation of Purchase Price to Assets

Asset	FMV	Percent of FMV	Allocated Purchase Price
Tillable land	$ 65,000	65%	$ 52,000
Barn	5,000	5%	4,000
Fences	2,000	2%	1,600
Timberland	13,000	13%	10,400
Standing timber	15,000	15%	12,000
Total	$100,000	100%	$ 80,000

Hominy can prorate the $80,000 price among the purchased assets using the ratio of the FMV of each parcel or improvement to $100,000, as shown in Figure 16.19. Note that all of the assets would be in Class V if the residual method were required.

If Hominy paid $120,000 for the farm, he could allocate the $120,000 purchase among the assets in the same manner as the $80,000 purchase price, which will result in a basis equal to 120% of the FMV of each of the parcels and improvements.

Hominy may prefer to use the residual method if he pays more than $100,000 for the farmland. Each asset would then have a basis equal to its FMV, and the excess $20,000 would be allocated to going concern value. I.R.C. § 197 permits purchased going concern value to be amortized over 15 years (180 months), so Hominy would have less basis in the nondepreciable tillable land and timberland.

Deducting Cost of Fertilizer

I.R.C. § 180 allows farmers to elect to deduct expenses paid or incurred during the tax year "for the purchase or acquisition of fertilizer, lime, ground limestone, marl, or other materials to enrich, neutralize, or condition land used in farming, or for the application of such material to such land." If a farmer does not make this election, the cost of the fertilizer or other materials is amortized over the useful life of the material. Famers make the election simply by deducting the cost of the fertilizer or other material on their income tax return.

Treas. Reg. § 1.180-1(b) refers to Treas. Reg. § 1.175-3 for the definition of *farmer* for purposes of I.R.C. § 180. Treas. Reg. § 1.175-3 says a taxpayer is in the business of farming if he or she cultivates, operates, or manages a farm for gain or profit, either as owner or tenant. It also treats a landowner who receives rent (either in cash or as a share of the crop) as a farmer if the rent is based on farm production. However, a taxpayer who receives a fixed rental without reference to production is engaged in the business of farming only if he or she participates to a material extent in the operation or management of the farm. The I.R.C. § 180 election to deduct fertilizer expenses is effective for only 1 year, and the election for a tax year can be revoked only with the IRS's consent [Treas. Reg. § 1.180-2].

Allocating Basis to Fertilizer or Nutrients

If taxpayers can show that fertilizer or nutrients are a separate asset that can be distinguished from the soil, they can allocate part of the purchase price of farmland to fertilizer or nutrients that are in the soil at the time of purchase. Similarly, taxpayers who receive land from a decedent can adjust the basis in the fertilizer or nutrients on the land to the date-of-death (or the estate tax alternate valuation date) value. However, the taxpayer has the burden of proving the existence and FMV of the fertilizer or nutrients.

Residual Fertilizer Supply

In T.A.M. 92-11-007 (December 3, 1991), the taxpayer was a corporation owned by A and B. The corporation purchased the buildings, irrigators, pumps, wells, grain bins, and the residual fertilizer supply on land that A and B purchased in their individual names and leased to the corporation on a 1-year lease. The lease automatically renewed each year unless either party notified the other party that it wanted to terminate the lease. The corporation amortized the amount allocated to the residual fertilizer supply over 7 years. The IRS held that a taxpayer must be the beneficial owner of the fertilizer to claim an amortization deduction for it, and it concluded that the corporation was not entitled to the deduction because A and B were the beneficial owners of the fertilizer.

The memo cited *Helvering v. F. & R. Lazarus & Co.,* 308 U.S. 252 (1939), a case in which a corporation claimed depreciation on three buildings that it occupied and used in its business as a department store. A bank held legal title because of a lending arrangement, but the stores had 99-year leases, with renewal and purchase options. The Supreme Court noted that someone who is not the owner "may nevertheless bear the burden of exhaustion of capital investment" and allowed the depreciation deductions.

The difference in the fertilizer ruling and the depreciation decision was the length of the leases.

Practitioner Note Position Is Not Precedent

A technical advice memorandum (TAM) is guidance from the IRS Office of Chief Counsel in response to technical or procedural questions that develop during an examination of a taxpayer's return, a consideration of a claim for a refund or credit, or any other matter involving a specific taxpayer. TAMs are issued only on closed transactions; they provide an interpretation of the proper application of tax laws, tax treaties, regulations, revenue rulings, or other precedents. The advice is a final determination of the IRS's position only with respect to the specific issue in the specific case in which the advice is issued.

I.R.C. § 6110(k)(3) provides that a TAM may not be used or cited as precedent. However, its conclusion may indicate the position the IRS will take in future cases, and the authorities cited in the TAM can be cited as precedents. In addition, Treas. Reg. §1.6662-4(d)(3)(iii) lists private letter rulings and technical advice memoranda issued after October 31, 1976, as authority that may be cited to avoid the accuracy-related penalty if tax is understated.

Additional Requirements for Amortization

Although T.A.M. 92-11-007 denied the amortization deductions because the corporation was not the beneficial owner of the fertilizer, the ruling also explains that a taxpayer must take the following four actions to qualify for an amortization deduction for the cost of fertilizer acquired with land:

1. Establish the presence and extent of the fertilizer.
2. Show the level of soil fertility that is attributable to the fertilizer applied by the prior owner.
3. Provide a base for measuring the increased fertility.
4. Provide evidence indicating the period over which the fertility attributable to the residual fertilizer will be exhausted.

If the advice memo is an indication of current IRS thinking, under the right set of facts the IRS will allow a purchaser of land to allocate part of the purchase price to the residual fertilizer supply and amortize that cost over the period during which the fertility attributable to the residual fertilizer will be exhausted.

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Example 16.20 Fall Application of Fertilizer

Bernadine Chavas applied $15,000 of fertilizer to 100 acres of her farmland in the fall of 2010 to prepare her land for the corn crop she intended to plant in 2011. Bernadine deducted the $15,000 on her 2010 Schedule F (Form 1040). Her plans changed, and she sold the 100 acres to Frederick Schmidt in February 2011 for $520,000.

In the sales contract, Bernadine and Frederick agreed that $483,000 of the purchase price was for the unimproved farmland, $22,000 was for tile line, and $15,000 was for the fertilizer Bernadine applied in the fall of 2010. Because Bernadine had applied the fertilizer, Frederick did not apply the fertilizer that he otherwise would have applied to the 100 acres for his 2011 corn crop.

The IRS is likely to agree that Frederick can allocate $15,000 of his purchase price to the fertilizer. If Frederick can show the rate in which the residual fertilizer supply is exhausted, the IRS is likely to allow him to amortize the $15,000 over the period in which it is exhausted.

The taxpayer in T.A.M. 92-11-007 amortized the cost of the residual fertilizer supply over 7 years, so the TAM does not discuss the possibility of claiming a deduction for the residual fertilizer supply under I.R.C. § 180. On its face, I.R.C. § 180 appears to allow Frederick to deduct the $15,000 on his 2011 income tax return because it does not limit the deduction to fertilizer applied by the taxpayer.

Practitioner Note Period of Exhaustion

If Frederick deducts the $15,000 on his 2011 income tax return under I.R.C. § 180, he does not have to provide evidence indicating the period over which the fertility attributable to the residual fertilizer will be exhausted because he is not amortizing the cost over that period. I.R.C. § 180 does not require a taxpayer to show that fertilizer or other material is exhausted.

The IRS is also likely to require Bernadine to report the $15,000 sale of fertilizer as the sale of an input with a zero basis that results in $15,000 of ordinary income.

State Reporting Requirements

Although Bernadine and Frederick are not required to agree on an allocation of the $520,000 purchase price or file Form 8594, most states require buyers and sellers of real property to report the transaction and identify the parties to the transaction. Therefore, the IRS and the state tax authority can identify the other party to the transaction and compare the allocations of the purchase price. If the buyer and seller have made the same allocation, the IRS or state tax authority is less likely to challenge the taxpayers' allocations.

Practitioner Note Land Received from a Decedent

If Bernadine, from Example 16.20, died in February 2011 after applying $15,000 of fertilizer in the fall of 2010, her heirs could argue that they inherited $483,000 of farmland, $22,000 of tile line, and $15,000 of fertilizer. The $483,000 basis in the farmland is not depreciable; the $22,000 basis in the tile line is depreciable over its 15-year recovery period; and the $15,000 basis in the fertilizer may be amortizable over the period of exhaustion. Because the heirs did not pay or incur an expense to the fertilizer, they cannot elect to deduct the $15,000 under I.R.C. § 180.

Satisfying the TAM Criteria

The requirements set out in T.A.M. 92-11-007 may be very difficult to satisfy in fact situations that are not as straightforward as Example 16.20. However, taxpayers may be successful in challenging the more onerous requirements in T.A.M. 92-11-007.

Beneficial Ownership

The facts in T.A.M. 92-11-007 were unusual in that the taxpayer paid for residual fertilizer on land purchased by related parties. In most cases, the same taxpayer will purchase the fertilizer and land, and that taxpayer will have no trouble showing that he or she has beneficial ownership of the fertilizer.

Presence and Extent of Fertilizer

Soil test technology makes it possible for taxpayers to document the presence and extent of nutrients in soil. Because soil test results are affected by how and where the soil samples are collected, taxpayers should be careful to document the sampling procedure. The sample should be taken before the buyer applies any additional fertilizer and ideally should be taken at the time of the purchase.

Level Attributable to Previous Owner

Presumably this requirement is a corollary of the previous requirement and is intended to distinguish fertilizer in the soil at the time the farmland is purchased from fertilizer applied after the purchase. It emphasizes the importance of having the soil tested at the time of the purchase.

Base for Measuring Increased Fertility

This is likely to be the most difficult requirement for the buyer to satisfy. Although taxpayers have found agronomists who will establish a base fertility for land and compare that base fertility with the fertility at the time of the purchase, the IRS can find other agronomists and soil scientists who will establish a different level of base fertility.

In T.A.M. 92-11-007, the taxpayer submitted information about the fertility of similar parcels of land in the area, but the IRS said that information did not provide a basis for measuring the increase in fertility because of the variability of soil fertility in general. It is not clear whether the baseline for comparing fertility to determine increased fertility is land in its native condition, land as normally maintained by farmers in the area, or some other baseline.

Period of Exhaustion

The period over which fertilizer is exhausted varies dramatically by the type of nutrient, soil type, and crop rotation. Therefore, it could be very difficult and expensive for a buyer to prove the period over which each nutrient in the residual fertilizer supply is exhausted.

In future cases, the IRS may look for other criteria than those discussed in T.A.M. 92-11-007. For example, the IRS could require the buyer to show that the residual fertilizer supply reduced or eliminated the need to apply fertilizer to the land. If the buyer applies fertilizer to the land without regard to the level of residual fertilizer, the IRS could argue that the residual fertilizer has no value and that none of the purchase price can be allocated to it.

Observation Presence of Residual Fertilizer

Landowners generally have no incentive to apply more purchased fertilizer than the amount needed for the current year's crop. They will get no immediate return from the excess fertilizer, and heavy rains could leach the excess out of the soil before it is used by a future crop. But there may be cases in which the landowner "stockpiled" fertilizer by applying more than was necessary because the cost of fertilizer was low or because he or she wanted to accelerate deductible expenses to reduce his or her taxable income.

Livestock farmers may apply more manure than is required to meet the current crop's nutrient need in order to dispose of the manure. In that case, land may have an excess nutrient supply when it is sold.

Cost Segregation

An alternative to the residual fertilizer supply approach is a cost-segregation approach in which the buyer allocates the price among the components of the purchased property according to the FMV of each component. Although this approach is not commonly used to allocate the cost of land, the Tax Court sanctioned allocating part of the cost of a building to the I.R.C. § 1245 components that are part of the building so that the taxpayer can depreciate part of the cost over a shorter recovery period [*Hospital Corporation of America v. Commissioner,* 109 T.C. 21 (1997)]. The IRS acquiesced to the concept in A.O.D. 1999-008 (September 8, 1999).

Under the cost-segregation approach, it is more useful to refer to the asset acquired with the land as *available nutrients* rather than *residual fertilizer supply,* because the scientific benchmarks are based on the amount of nutrients in the soil that are available for use by a crop.

Authority for Other Asset Allocations

Regulations and case law allow taxpayers to allocate part of the purchase price of land to assets acquired with the land and by analogy are precedents for allocating part of the purchase price of land to available nutrients acquired with the land.

Timber

Treas. Reg. § 1.611-3(f) allows taxpayers to use scientific methodology to allocate part of the purchase price of land to standing timber acquired with the land. A consulting forester estimates the value of trees on the land at the time the land was purchased by carrying out a *back cruise,* as explained in Issue 8, "Tree Farming."

The value of the timber on the date the land was purchased is the estimated volume of each type of timber product multiplied by the historic price for each product. The purchase price is then allocated to the basis of the land and the basis of the timber using the FMV of each, as illustrated earlier in Example 16.19.

Water Rights

In *Gladden v. Commissioner,* 262 F.3d 851 (9th Cir. 2001), the taxpayers sold water rights and argued that part or all of the purchase price of the land to which the rights were attached could be allocated to the basis of the water rights and reduce the gain they must recognize upon sale of the water rights. At the time the taxpayers purchased the land, the water rights were expected but had not yet legally vested.

The court stated that if the water rights had legally vested at the time the land was purchased, Treas. Reg. § 1.61-6(a) would clearly allow the taxpayers to allocate the purchase price between the basis in the land and the water rights.

The court also noted that if the water rights were not expected at the time the land was purchased, then none of the purchase price could be allocated to the water rights because the taxpayers would not have paid a premium for the land in order to acquire the water rights. It cited two authorities for this position:

- In *Plow Realty Co. of Texas v. Commissioner,* 4 T.C. 600 (1945), the Tax Court held that because land was originally valued solely for cattle-grazing qualities, a subsequent sale of the mineral rights had a zero cost basis.
- In Rev. Rul. 66-58, 1966-1 C.B. 186, the IRS did not allow any of the cost basis in land to be allocated to a cotton allotment that was acquired after the land was purchased and was sold separately from land.

In *Gladden,* the appellate court concluded that the purchase price could be allocated to the water rights to the extent of the premium the taxpayer paid for the land because of the expected water rights, and it remanded the case to the Tax Court to determine that premium. Citing *Inaja Land Co., Ltd. v. Commissioner,* 9 T.C. 727 (1947), the court also held that if it is "impracticable or impossible" to determine that premium, then the taxpayers could use their entire cost basis in the land to reduce their gain on sale of the water rights.

Under Rev. Proc. 66-11, 1966-1 C.B. 624, the basis of water rights for land in the Ogallala Formation is the difference in value of land with a supply of ground water and land without a supply of ground water.

Sod

In *Meyers v. Commissioner,* 66 T.C. 235 (1976), the Tax Court held that sod is a natural deposit, and it allowed the taxpayer to claim a depletion allowance under I.R.C. § 611. The taxpayer showed that after 16 cuttings of sod, the available topsoil would be exhausted and it would not be economically feasible to raise sod or grain crops. The residual value of the land would be 66% of its former value as grain- or sod-producing land.

In Rev. Rul. 79-411, 1979-2 C.B. 246, the IRS ruled that soil and loam are natural deposits and taxpayers can reduce their gain from the sale of topsoil and loam by an allowance for cost depletion.

Practitioner Note Exhaustion of Soil Nutrients

In the *Meyers* case, the IRS argued that the taxpayer's operations were more properly characterized as a farming activity in which there is a foreseen diminution in the capacity of the land to produce crops with each planting. The court rejected that analogy but did concur with the IRS that "owners of farmland are specifically denied a deduction for exhaustion and wear and tear due to erosion, wind, or *privation of soil nutrients*" (emphasis added), and it cited Treas. Reg. §§ 1.167(a)-6(b) and 1.612-1(b)(1).

If taxpayers cannot claim a deduction for privation of soil nutrients, then purchasers of land may be denied a deduction for the available nutrients they purchase with the land. However, contrary to the court's statement, Treas. Reg. §§ 1.167(a)-6(b) and 1.612-1(b)(1) do not appear to specifically prohibit a deduction for privation of soil nutrients.

- Treas. Reg. § 1.167(a)-6(b) allows taxpayers to depreciate buildings, farm machinery, and other physical property, but not land. If taxpayers can show that the available nutrients are an asset other than the land, this regulation does not prohibit a deduction for the exhaustion of the available nutrients.
- Treas. Reg. § 1.612-1(b)(1) states, "In the case of any *mineral property* the basis for cost depletion does not include amounts representing the cost or value of land for purposes other than mineral production." That does not prohibit a deduction for the exhaustion of available nutrients in farmland.

Cost Segregation of Available Nutrients

Under the cost-segregation approach, the purchase price is first allocated among the land, buildings, fences, tile lines, timber, mineral rights, and other assets purchased with the land. Then the amount allocated to the land is further allocated between the soil as a vessel for holding nutrients and the available nutrients in the soil. There is no case history for this approach, but it is similar to the cost segregation allowed in the *Hospital Corporation of America* case.

By analogy, taxpayers can argue that they can allocate part of the cost of land to the nutrients in the soil and amortize the cost of those nutrients over their expected period of exhaustion.

Example 16.21 Cost Segregation for Nutrients

Steiner Olsen paid $520,000 ($505,000 purchase price plus $15,000 transaction costs) to buy 100 acres of land that had a drainage tile system and high levels of available nutrients (as measured by soil tests) because the seller, Gloria Brown, had spread more manure than was needed for annual crop production. Steiner and Gloria did not discuss, and had no agreement regarding, an allocation of the purchase price to the tile line or available nutrients in the soil. Because the purchase was not a purchase of a trade or business, neither Steiner nor Gloria was required to file Form 8594.

Shortly after the purchase, Steiner's tax preparer told him that he could allocate part of the purchase price to the tile line and the nutrients in the soil if he could prove their value. Steiner obtained a map of the tile line from Gloria that showed the tiling system is 10 years old. Steiner took the map to a tiling contractor who estimated that the system had another 40 years of life and would cost $27,500 to replace. Therefore, Steiner estimates the value of the tiling system to be $22,000 [$27,500 × (40 years ÷ 50 years)]. The cost recovery period for drainage tile is 15 years.

Steiner paid an agronomist $2,000 to analyze the soil. The agronomist compared the available nutrients in the soil with the optimal level of available nutrients according to the recommendations of the land grant university in Steiner's state and found there were excess amounts of phosphorus (P) and potassium (K). The agronomist valued the excess available nutrients by multiplying the excess amount by the cost of purchasing and applying that much of each nutrient. Finally, the agronomist determined the period over which the excess available nutrients would be used up by crops in a normal crop rotation if no additional nutrients were added to the soil. Figure 16.20 reports the agronomist's findings.

Figure 16.20 Amount, Value, and Exhaustion Period of Excess Available Nutrients

Nutrient	Phosphorus	Potassium	Total
Available nutrients as measured by soil tests	35 ppm	113 ppm	
Optimal available nutrients[1] (ppm P or K)	20 ppm	100 ppm	
Excess available nutrients (ppm P or K)	15 ppm	13 ppm	
Conversion factor[2]	18	7	
Excess available nutrients[3] (pounds P_2O_5 or K_2O/acre)	270	91	
Cost per pound	59¢	47¢	
Value ($/acres)	$159	$43	$202
Pounds removed per year per acre	75	90	
Exhaustion period (excess pounds ÷ removal rate)	3.6 years	1 year	

[1] Optimal available nutrients is the level recommended by the land grant university in Steiner's state for his crop rotation.

[2] The conversion factors are the number of pounds of P_2O_5 per acre that must be added to increase the phosphorus by 1 ppm or removed to decrease phosphorus by 1 ppm, and the pounds of K_2O per acre that must be added to increase the potassium by 1 ppm or removed to decrease potassium by 1 ppm.

[3] The excess pounds per acre of each nutrient are the excess ppm of that nutrient multiplied by the conversion factor described in footnote 2.

Based on this information, Steiner estimated the FMV of the excess phosphorus to be $15,900 ($159 per acre × 100 acres) and the FMV of the excess potassium to be $4,300 ($43 per acre × 100 acres).

Steiner hired an appraiser who reported that the FMV of comparable farmland without a tile system and without excess nutrients was $510,000. Therefore, Steiner allocated the $520,000 purchase price among the land, tile system, and available nutrients, as shown in Figure 16.21.

Figure 16.21 Allocation of Steiner Olsen's $520,000 Purchase Cost

Asset	FMV	Allocation Formula	Allocated Cost
Land	$510,000	($510,000 ÷ $552,200) × $520,000	$ 480,261
Tile system	22,000	($22,000 ÷ $552,200) × $520,000	20,717
Phosphorus	15,900	($15,900 ÷ $552,200) × $520,000	14,973
Potassium	4,300	($4,300 ÷ $552,200) × $520,000	4,049
Total	$552,200		$ 520,000

Steiner amortized the $14,973 purchase price allocated to the phosphorus straight-line over the 3.6-year estimated period of exhaustion (Figure 16.20), deducting $4,159 ($14,973 ÷ 3.6) in the year of the purchase and each of the next 2 years, and the remaining $2,496 in the fourth year. Steiner deducted the entire $4,049 allocated to the potassium in the year he purchased the land because the agronomist estimated the period of exhaustion for the potassium to be 1 year.

Practitioner Note I.R.C. § 180 Deduction

Because Steiner has allocated part of the purchase price to *available nutrients* in the soil rather than to a *residual fertilizer supply*, he is likely to be ineligible for the I.R.C. § 180 election to deduct the $19,022 ($14,973 + $4,049) that he allocated to the nutrients in the year he purchased the land.

Question 1.
Does Gloria Brown (the seller) have to allocate the same amounts as the sales price of the land, tile system, and nutrients?

Answer 1.
Tax law does not require Steiner and Gloria to agree on and report the same amounts as the sale and purchase price of each asset. However, if the IRS or the state tax authority audits either of their returns, it could identify the other party and require the other party to use the same FMVs of each asset to allocate the price.

For example, if the IRS audited Steiner's return and agreed with his allocation of the purchase price, it could identify Gloria as the seller from state land records and require her to use the same FMVs to allocate her net proceeds from the sale. If her transactions costs were $25,000, her $480,000 ($505,000 – $25,000) net proceeds would be allocated as shown in Figure 16.22.

Figure 16.22 Allocation of Gloria Brown's $480,000 Net Proceeds

Asset	FMV	Allocation Formula	Allocated Price
Land	$510,000	($510,000 ÷ $552,200) × $480,000	$ 443,318
Tiling system	22,000	($22,000 ÷ $552,200) × $480,000	19,123
Phosphorus	15,900	($15,900 ÷ $552,200) × $480,000	13,821
Potassium	4,300	($4,300 ÷ $552,200) × $480,000	3,738
Total	$552,200		$ 480,000

Gloria's gain or loss on the land is I.R.C. § 1231 gain or loss; her gain on the tile system is ordinary income under the I.R.C. § 1245 depreciation recapture rules; and the proceeds from the nutrients are ordinary income without any reduction for basis because the manure spread on the land had no income tax basis.

Question 2.
Can Steiner allocate any of the purchase price to nutrients if the soil tests show there was less than the optimal level of each of the nutrients?

Answer 2.
If the nutrient levels are at or below the optimal level, the agronomist is likely to conclude that none of the purchase price can be allocated to the available nutrients. Steiner must then allocate his $520,000 purchase price between the land and tile system using their respective FMVs.

Question 3.
How should Steiner report the $2,000 fee he paid to the agronomist?

Answer 3.
The agronomist's work is required only because of the income tax reporting requirements. Therefore, Steiner can deduct the $2,000 fee as a miscellaneous expense on line 32 of Schedule F (Form 1040). It does not matter whether he was able to use the agronomist's report to allocate some of the purchase price to nutrients.

Planning Pointer Effect of a Like-Kind Exchange

If a taxpayer acquires land in a like-kind exchange, improvements on the land (such as buildings, fences, and tile lines) and natural resources on the land (such as timber, gravel, and minerals) are treated as like-kind property. Fertilizer and real estate are probably not like-kind property. Therefore, any value allocated to fertilizer is likely to not be qualified replacement property in a like-kind exchange. Taxpayers could argue that nutrients are part of the land and are therefore real property that is qualified replacement property.

Conclusion

Although there is very little guidance on allocating part of the purchase price of land to fertilizer purchased with the farmland, if taxpayers can show the amount and value of the residual fertilizer supply or excess available nutrients in the soil and the period during which the excess nutrients will be exhausted, they have a reasonable argument for amortizing the value of the fertilizer or nutrients over the period of exhaustion. Taxpayers can arguably elect to deduct the cost of the residual fertilizer in the year of the purchase under I.R.C. § 180 and in that case do not need to show the period of exhaustion.

Similarly, taxpayers who receive farmland from a decedent can arguably adjust the basis of the residual fertilizer supply or excess available nutrients to the FMV on the date of death or alternate valuation date.

Until there is further guidance from the IRS or court cases, it is difficult to know what baselines will be accepted for measuring residual fertilizer supply or excess available nutrients. It is also hard to predict what precision of soil sampling will be required to prove the presence of residual fertilizer or available nutrients. Consequently, it is hard to predict whether a taxpayer will succeed in allocating part of the purchase of price of land to fertilizer or nutrients or in adjusting the basis of fertilizer or nutrients to the date-of-death (or alternate valuation date) value.

If the courts or the IRS sanction a high baseline for measuring residual fertilizer supply or excess available nutrients, there may be only a few instances in which there is residual fertilizer or excess nutrients over the baseline. If the courts or the IRS sanction a very precise method of sampling soil, the cost of sampling may exceed the tax savings from allocating basis to fertilizer or nutrients.

ISSUE 8: TREE FARMING

For many owners of farmland, timber and its economic value is in sight but out of mind until there is an opportunity to sell trees that are ready for harvest.

The opportunity raises several questions regarding timber sales and related transactions. This section discusses the issues that arise from infrequent sales of timber and from sales by taxpayers who are engaged in the trade or business of tree farming.

Taxation of Timber Sales

For income tax purposes, taxpayers who sell standing timber may be investors or in the timber business. An investor's gain or loss from the sale of standing timber is a capital gain or loss. If the taxpayer is in the timber business, the tax treatment depends both on how the timber is sold and how the taxpayer chooses to treat the sale.

1. If the taxpayer cuts the timber (or pays a contractor to cut it) and sells the cut timber, the gain or loss is all ordinary gain or loss unless the taxpayer elects to treat the cutting as a sale under I.R.C. § 631(a). If the taxpayer makes the I.R.C. § 631(a) election, the timber's FMV is determined as of the first day of the tax year in which it is cut. The difference between that FMV and the timber's basis is I.R.C. § 1231 gain or loss that is recognized in the year that the timber is cut and netted with the taxpayer's other I.R.C. § 1231 gains or losses for the year. The subsequent difference between that FMV and the net proceeds from selling the cut timber is still ordinary income or loss.
2. If the taxpayer sells standing timber, the gain or loss is I.R.C. § 1231 gain or loss that is netted with the taxpayer's other I.R.C. § 1231 gains or losses for the year [I.R.C. § 631(b)].

Law Change Sales before 2005

Sales of standing timber before 2005 qualified for I.R.C. § 1231 treatment only if the timber owner sold the timber under a contract that based the payment to the timber owner on the amount of timber products sold (pay-as-cut contract, also called a sale with a retained economic interest). Gain or loss from outright sales of timber was ordinary gain or loss.

3. The net proceeds from annual sales of timber products (such as firewood or pine straw) and from the sale of timber products after the timber is cut (such as tree stumps) is ordinary income or loss.

Investors

For most landowners, including farmers, timber sales are infrequent—occurring only once or twice during the landowner's lifetime for a given tract of land. Gain or loss from lump-sum sales of standing timber is treated as a capital gain or loss under I.R.C. § 1221.

Example 16.22 Lump-Sum Sale of Timber

Greene Ashe engaged Knotty Pine, a consulting forester, to solicit lump-sum bids for his standing timber that is ready for harvest. Knotty secured several bids and accepted a $100,000 bid from Trees-a-Fallin, LLC. Knotty deducted his $6,000 commission from the sale proceeds and paid $94,000 to Greene.

When Greene purchased the land for $40,000 many years ago, he allocated $25,000 of his cost to the land and $15,000 to the standing timber, based on the classes of merchantable timber at the time. Greene consistently reported his timber expenses as investment expenses. His $79,000 gain is computed as shown in Figure 16.23.

Figure 16.23 Greene Ashe's Sale of Timber

Sale price	$100,000
Selling costs	(6,000)
Basis of timber	(15,000)
Gain	$ 79,000

Because the timber was held for longer than a year, Greene's gain is long-term capital gain that is reported on Form 8949, Sales and Dispositions of Capital Assets, and Schedule D (Form 1040), Capital Gains and Losses.

If a taxpayer inherits land with standing timber, the holding period is deemed to be long-term regardless of how long either the taxpayer or the decedent held the land [I.R.C. § 1223(9)]. The timber's basis is its FMV on the decedent's date of death or estate tax alternate valuation date, except for some deaths in 2010. Thus, a sale of timber that closely follows the prior owner's death may result in little, if any, gain.

Observation Sale at a Loss

Taxpayers who purchased or inherited standing timber 4 or 5 years ago may have a capital loss on the sale of timber in 2011. The bursting of the housing bubble in 2008 and subsequent meltdown of the housing market also reduced timber values because timber prices are tied directly to the construction industry. Only $3,000 of net capital losses can be deducted from ordinary income each year. The balance is carried forward.

When the donor's basis transfers to the recipient of a gift, the recipient tacks the donor's holding period onto his or her own holding period [Treas. Reg. § 1.1223-1(b)]. If the recipient holds timberland as an investment, he or she computes and reports gain or loss on infrequent timber sales as illustrated in Example 16.22. The basis of a gift is explained later in this chapter, in the "Basis of Timber" section.

Timber Business

If a taxpayer is in the timber business, the tax treatment of the sale of timber depends on how it is sold and how the taxpayer chooses to treat the sale.

Sale of Cut Timber

Gain or loss from the sale of cut timber is ordinary gain or loss unless the taxpayer elects to treat all timber that is cut (severed from the roots) during the year of the election, as well as subsequent years, as a sale or exchange [I.R.C. § 631(a)]. If the taxpayer makes the I.R.C. § 631(a) election, then the difference between the timber's FMV (on the first day of the tax year in which it is cut) and its basis is I.R.C. § 1231 gain or loss that is netted with the taxpayer's other I.R.C. § 1231 gains or losses for the year. The difference between the net proceeds from selling the cut timber and the timber's FMV on the first day of the tax year is ordinary income or loss.

To qualify for this election, the standing timber must be cut by the owner or by someone who has held a contract right to cut the timber for more than a year. The holding period must include the first day of the tax year in which the timber is cut. A *contract right* is an unrestricted right to use or sell the cut timber.

Taxpayers should attach an election statement to their income tax return [Treas. Reg. § 1.631-1(c)], report the gain or loss as of the first day of the tax year on Form 4797, and report the gain or loss from the sale of the cut timber on a business form such as Schedule F (Form 1040), Profit or Loss From Farming.

Example 16.23 Timber Sale with an I.R.C. § 631(a) Election

Lobb Lolly is in the trade or business of growing pine trees for construction timber. He elected to treat the cutting of his timber as a sale or exchange under I.R.C. § 631(a). In September 2011, Lobb cut and processed 400,000 board feet of lumber and sold it for $200,000. He incurred $12,000 of harvesting costs and $35,000 of milling expenses.

A consulting forester estimated the FMV of the 400,000 board feet of standing timber on January 1, 2011, to be $140,000. Lobb had a $12,000 basis in the timber that was cut.

Lobb's sale is reported in two steps, first as an I.R.C. § 1231 transaction on Form 4797, and second as an ordinary business transaction on Schedule F (Form 1040), as shown in Figures 16.24 and 16.25. His $187,000 basis for the second step is the sum of the $140,000 FMV on January 1, 2011, his $12,000 harvesting costs, and his $35,000 milling expenses. Lobb also must include the election statement shown in Figure 16.26 with his 2011 income tax return.

Figure 16.24 Lobb Lolly's Form 4797 with I.R.C. § 631(a) Election

Form **4797**

Department of the Treasury
Internal Revenue Service (99)

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))
► **Attach to your tax return.** ► **See separate instructions.**

OMB No. 1545-0184
2011
Attachment Sequence No. **27**

Name(s) shown on return: **Lobb Lolly**
Identifying number: **222-33-4444**

1 Enter the gross proceeds from sales or exchanges reported to you for 2011 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) **1**

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
Timber	05/15/1996	01/01/2011	140,000		12,000	128,000
Sec. 631(a) election						

Figure 16.25 Lobb Lolly's Schedule F (Form 1040)

SCHEDULE F (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Farming
► **Attach to Form 1040, Form 1040NR, Form 1041, Form 1065, or Form 1065-B.**
► **See Instructions for Schedule F (Form 1040).**

OMB No. 1545-0074
2011
Attachment Sequence No. **14**

Name of proprietor: **Lobb Lolly**
Social security number (SSN): **222-33-4444**

A Principal crop or activity: **Tree Farming**
B Enter code from Part IV ► 1 1 3 0 0 0
C Accounting method: ☑ Cash ☐ Accrual
D Employer ID number (EIN), if any

E Did you "materially participate" in the operation of this business during 2011? If "No," see instructions for limit on passive losses. ☑ Yes ☐ No
F Did you make any payments in 2011 that would require you to file Form(s) 1099 (see page F-3 of the instructions) . . . . . ☑ Yes ☐ No
G If "Yes," did you or will you file all required Forms 1099? . . . . . ☑ Yes ☐ No

Part I **Farm Income—Cash Method.** Complete Parts I and II (Accrual method. Complete Parts II and III, and Part I, line 9.)

1a	Specified sales of livestock and other resale items (see page F-3)	1a			
b	Sales of livestock and other resale items not reported on line 1a	1b	200,000		
c	Total	1c	200,000		
d	Cost or other basis of livestock or other items reported on line 1c	1d	187,000		
e	Subtract line 1d from line 1c			1e	13,000

Figure 16.26 I.R.C. § 631(a) Election

Election to Treat Cutting of Timber as Sale or Exchange under I.R.C. § 631(a)

Lobb Lolly, SSN 222-33-4444
Form 1040, Tax Year 2011

Taxpayer Lobb Lolly elects to treat the cutting of timber as a sale or exchange under I.R.C. § 631(a). The computation under §§ 631 and 1231 is found below.

Fair market value of timber cut (01/01/2011)	$140,000
Adjusted basis of timber for depletion	(12,000)
Gain on sale or exchange	$128,000

Sale of Standing Timber

Timber owners often sell standing timber rather than cutting the timber and selling the logs or lumber. Sales of standing timber after 2004 qualify for I.R.C. § 1231 treatment whether they are outright sales or sales with a retained economic interest. Taxpayers report the sales on Form 4797.

Example 16.24 Sale of Standing Timber

Swampy Waters is a vegetable farmer who has 100 acres of low-lying land that is not fit for raising vegetables because of frequent spring and autumn flooding. However, it is very suitable for growing high-grade hardwoods for the furniture and veneer industries.

When Swampy purchased the land, he allocated $200,000 of the purchase price to the existing trees. He has recovered $50,000 of that basis in prior-year timber sales, which reduced his basis in the standing timber to $150,000. At the beginning of 2011, Swampy estimates he has 1,000 MBF of standing timber (1 MBF = 1,000 board feet). Therefore, his basis is $150 per MBF ($150,000 ÷ 1,000 MBF) at the beginning of 2011.

Swampy has a long-term pay-as-cut contract with Beautiful, Elegant, Lovely, China Hutches, LLC (BELCH) that allows BELCH to harvest his trees for its furniture products. Figure 16.27 shows the timber that BELCH removed from Swampy's land in 2011 and the amount Swampy received for that timber. After subtracting his $15,000 basis in the 100 MBF from the $290,000 of proceeds, he has $275,000 of gain to report in Part I of Form 4797.

Figure 16.27 Swampy Waters's 2011 Gain from 2011 Timber Sales

Item	MBF	Amount
Species		
Walnut	45	$ 90,000
Cherry bark oak	50	150,000
Bird eye maple	5	50,000
Total sales	100	$290,000
Timber basis ($150 per MBF × 100 MBF)		(15,000)
Gain		$275,000

Practitioner Note Information Reporting for Timber Sales

Treas. Reg. § 1.6045-4(b)(2)(i)(E) requires a real estate reporting person (that is, the person responsible for closing a real estate transaction) to file Form 1099-S, Proceeds From Real Estate Transactions, for timber sales made after May 28, 2009.

Form 1099-S must be sent to the seller by February 15 of the year following the sale and to the IRS by February 28. If the forms for 2011 sales are filed electronically, they are due to the IRS by April 2, 2012.

Sale of Timber Products

Farmers who have timber property may have sales of associated products (such as *lighter wood* from stumps that are no longer attached to the ground) after standing timber is harvested. They may also sell products such as firewood and pine straw. These products are generally treated as sold in the ordinary course of business, and the gain on sale is ordinary income.

Example 16.25 Sale of Firewood

Tripp Wire harvested hardwood timber from a 5-acre tract on his farm. The loggers left the undesired tree tops on the land after harvest. Tripp cuts the tree tops into firewood-size pieces and sells the cured firewood for $125 per cord.

Tripp reports the firewood sales as income on line 8b of Schedule F (Form 1040) as part of his farm income that is subject to ordinary income tax rates as well as self-employment tax. Tripp can deduct his expenses (such as fuel, bar oil, replacement saw chains, and depreciation of tools) in Part II of his Schedule F (Form 1040).

Basis of Timber

Taxpayers bear the burden of proving their tax basis in timber, as they do with any asset. If a seller has no record to establish basis, the IRS will assume the basis is zero and treat the net proceeds from the sale as gain.

Unadjusted Basis

A taxpayer's unadjusted income tax basis in property depends on how the taxpayer acquired the property.

- The basis of purchased property is the purchase price plus transaction costs [I.R.C. § 1012(a)].

- The basis of property received by gift generally is a carryover basis from the donor of the property [I.R.C. § 1015]. However, the basis of gifted property cannot exceed its FMV on the date of the gift. If the gift triggered a gift tax liability, the basis increases by the amount of gift taxes actually paid that is attributable to the property's appreciation in value.
- The basis of property received from a decedent is the property's FMV on the decedent's date of death or the estate tax alternate valuation date [I.R.C. § 1014(a)]. If the estate elects to use the I.R.C. § 2032A special-use valuation rules, the property's basis is its special-use value.

Property received in a nontaxable transfer (such as a like-kind exchange, tax-free contribution to an entity, or transfer between spouses) has a carryover basis from the transferor.

Allocation of Original Basis

Taxpayers who buy land with timber on it should allocate the purchase price among the land, timber, and any improvements that are on the land using FMV ratios. If the purchase price is less than (or more than) the sum of the FMVs of the individual assets, the purchase price is prorated among the assets. New owners should make the basis allocation at the time of acquisition, when all of the details regarding the acquisition are fresh.

Example 16.26 Allocation of Purchase Price

Douglas Firr hired an appraiser to estimate the value of land he wanted to buy and a consulting forester to estimate the value of standing timber on the land. The forester concluded that the timber was worth $40,000, and the appraiser concluded that the land was worth $60,000 based on sales of comparable land without timber. The seller accepted Douglas' $100,000 offer, and Douglas allocated $40,000 of his purchase price to the timber and $60,000 to the land.

If Douglas negotiated a $90,000 purchase price, his basis in the timber would be $36,000 [($40,000 ÷ $100,000) × $90,000] and his basis in the land would be $54,000 [($60,000 ÷ $100,000) × $90,000].

If timberland is acquired in a like-kind exchange, the carryover basis and the boot paid for the land must be allocated among the land, timber, and any improvements on the land.

Example 16.27 Allocation of Carryover Basis and Boot

Douglas Firr from Example 16.26 acquired the same land and timber with a $100,000 FMV, but he paid for it with $85,000 of proceeds from relinquished property in a deferred like-kind exchange and $15,000 of boot. Douglas's basis in the relinquished property was $35,000, so his total basis in the acquired land and timber is $50,000.

Douglas allocates $20,000 [($40,000 ÷ $100,000) × $50,000] of his basis to the timber and $30,000 [($60,000 ÷ $100,000) × $50,000] to the land.

Reconstructing Basis

Timber owners who did not allocate their purchase price at the time they purchased the land can reconstruct their timber basis at a later time [Treas. Reg § 1.611-3(f)]. One accepted method of reconstructing timber basis is called a *back cruise.* A consulting forester first determines the quantity of each species of trees currently on the land. The forester then estimates how much of that quantity was present when the owner bought the land by boring plugs out of a sample of trees and counting the annual growth rings beginning from the outside of the trunk until he or she reaches the ring that represents the year the land was purchased. The remaining rings were there when the land was purchased, and they indicate the size of the trees at the time of purchase.

Example 16.28 Back Cruise

Redd Oak inherited timberland from his grandfather in 1978. The executor listed the value of the land as $100,000 in the estate documents, but the executor did not allocate the $100,000 between the land and the timber. In 2011, Redd sold the furniture-grade hardwood timber on the entire tract. Before the trees were cut, Redd hired a consulting forester to determine his timber basis using the back cruise method. From samples bored from trees, the forester estimated the quantity of each timber species that was on the property in 1978. Using the price of timber in 1978, he then estimated that the FMV of the timber in 1978 was $60,000.

Form T (Timber)

Taxpayers who are in the timber business are required to track the basis of each class of timber product, such as premerchantable timber, pulpwood, chip-n-saw (midsize timber), posts, and logs. As trees grow they move into different product classes, and the basis moves with the product. Generally, basis decreases per unit as trees grow because the basis is spread over more units.

Form T (Timber), Forest Activities Schedule, tracks the basis that is available for depletion. Taxpayers must complete and file Form T (Timber) if they take any of three actions:

1. They claim a deduction for depletion of timber.
2. They make an outright sale of timber under I.R.C. § 631(b).
3. They elect under I.R.C. § 631(a) to treat the cutting of timber as a sale or exchange.

Practitioner Note Occasional Sales

Taxpayers who sell timber only occasionally are not required to file Form T (Timber). The IRS instructions for the form state that an occasional sale means one or two every 3 or 4 years. However, preparing Form T (Timber) is useful to these taxpayers for maintaining records of timber basis.

Example 16.29 Filing IRS Form T

June E. Purr, LLC owns multiple tracts of timberland and sells timber several times each year. Because the LLC is in the timber business, it is required to file Form T (Timber) to report the cost basis of its land and timber accounts. June E. Purr, LLC's timber accounts include poles, veneer-grade timber, and premerchantable timber.

Question 1.
What happens to the cost basis that is assigned to the premerchantable timber as the trees grow?

Answer 1.
As the trees grow, the cost basis is reallocated to the new timber products that arise from the natural and managed growth of the trees. For example, if the basis of the premerchantable timber was initially \$20,000, and 15 years after acquisition the trees had grown to become two separate classes (pulpwood, and chip-n-saw), the \$20,000 basis is now allocated to the two product classes and reported on an updated Form T (Timber) for the specific tract of land.

Question 2.
What effect does a thinning sale of pulpwood have on basis?

Answer 2.
A prorated portion of the cost basis allocated to the pulpwood account is deducted as depletion for the pulpwood that was harvested and sold. The remaining basis is recorded on a Form T (Timber) that is attached to the taxpayer's income tax return.

16

Timber Expenses

The tax treatment of expenses incurred by timber owners depends on the type of expense and the tax status of the timber activity. I.R.C. § 263A(c)(5) provides an exception from the uniform capitalization rules for timber and ornamental trees, other than Christmas trees (an evergreen tree that is more than 6 years old when it is severed from its roots).

Carrying Charges (Investors)

For most taxpayers, holding timber is a long-term investment. These taxpayers incur carrying charges such as management costs, taxes, and interest. Investors may elect under I.R.C. § 266 to capitalize otherwise deductible carrying charges, such as interest and property taxes, for real property. Corporate owners of timber may deduct carrying charges from other corporate income if they do not elect capitalization. Restrictions apply to an individual investor's deductions.

Management Costs

Management costs, such as the cost of a forestry management plan, are deductible by individual taxpayers who hold timber activities as an investment only as miscellaneous itemized deductions on Schedule A (Form 1040), Itemized Deductions, subject to the 2%-of–adjusted gross income (AGI) floor.

For example, an individual who has \$100,000 of AGI has a \$2,000 floor (2% × \$100,000) on miscellaneous itemized deductions. If the taxpayer paid the consulting forester $2,500 and had no other miscellaneous itemized deductions, the taxpayer can deduct $500 of the forester's fee if he or she itemizes deductions. If the taxpayer does not treat the fee as an itemized deduction, he or she can elect to capitalize it into the timber's basis to be recovered when the timber is sold.

Taxes

Property and other deductible taxes that are attributable to the timber activity may be deducted by individual investors as an itemized deduction that is not subject to the 2%-of-AGI floor. If the taxpayer does not itemize deductions, there is no benefit in the current year, so the taxpayer should elect to capitalize the taxes into the basis of the timber, to recover the expense through depletion when the timber is sold.

Interest

An individual investor's itemized deduction for investment interest expense is limited to his or her investment income for the tax year. For example, if an individual incurred $6,000 of interest expense, but received only $2,000 of investment income, the current deduction is limited to $2,000, with an unlimited carryforward. However, the taxpayer may elect to capitalize the entire $6,000 of interest into the timber basis to be recovered upon sale of the timber.

Practitioner Note I.R.C. § 266 Election

The election is made on a year-by-year basis. The taxpayer must file a statement with his or her original tax return indicating the item or items that the taxpayer elects to treat as chargeable to capital account.

Costs of Sale

Costs that are directly related to the sale of timber are subtracted from the gross sales price to reduce the gain or increase the loss from the sale. Examples include the following costs:

- Hiring a consulting forester to solicit bids for standing timber and to manage the logging
- Paying for a land survey to establish the property boundary, to prevent inadvertent cutting of a neighbor's timber
- Construction of temporary logging roads that provide access to the timber property
- The purchase of a temporary easement to cross a neighbor's land, to harvest timber from a landlocked property

An aggressive position as a cost-of-sale expense is the construction of a bridge to harvest a back corner area that may be inaccessible during wetter periods of the year. The bridge is built with the express purpose of providing access to the timber and for reforestation. Once the property is reforested, it will be many decades before the next timber harvest is undertaken. The conundrum is that the bridge potentially will have a long useful life and may be deemed to be a land improvement that needs to be depreciated, with the depreciation expense capitalized into the new timber stand's basis. Specific IRS guidance was not found by the author of this issue. A taxpayer and tax practitioner should be circumspect in making a decision under a similar set of circumstances.

Sales costs are deducted along with the basis of the timber when the sale is reported on Form 4797, Sales of Business Property, or Form 8949, Sales and Other Dispositions of Capital Assets.

Reforestation Expenses (Deduction and Amortization)

Following a timber harvest, landowners incur expenses to quickly place the land back into timber production. These reforestation expenses include costs for site preparation, seed or seedlings, labor, tools, fertilizer, lime, herbicides, and depreciation of equipment.

I.R.C. § 194(b) allows qualifying taxpayers to deduct up to $10,000 of reforestation expenses each tax year **per individual tract** of timberland [I.R.C. § 194(b)(1)(B)]. I.R.C. § 194(a) allows qualifying taxpayers to amortize the reforestation expenses that are not deducted under I.R.C. § 194(b) over an 84-month period using the half-year convention.

To qualify for the reforestation deduction or amortization, the land that is reforested must be located in the United States and be used in the commercial production of timber. Expenses that are reimbursed by any governmental reforestation cost sharing payments cannot be deducted unless the cost sharing payment is included in gross income [I.R.C. § 194(c)(3)(B)].

Practitioner Note Ornamental Trees

Growers of Christmas and other ornamental trees do not qualify for the I.R.C. § 194 deduction of reforestation expenses.

Individual taxpayers, estates, partnerships, and corporations can qualify for either the deduction or amortization. The $10,000 deduction limit is reduced to $5,000 for individual taxpayers whose filing status is married filing separately. The deduction limit applies at the partnership level as well as to each partner and to S corporations as well as each shareholder [I.R.C. § 194(b)(2)(B)].

Estates must allocate the reforestation expenses between the estate and the beneficiaries on the basis of the estate income that is allocable to each [Treas. Reg. § 1.194-2(b)(2)]. The expenses apportioned to both the estate and the beneficiaries qualify for either the deduction or the 84-month amortization.

Trusts do not qualify for the I.R.C. § 194(b) deduction [I.R.C. § 194(b)(1)(B)(iii)], but they can amortize reforestation expenses under I.R.C. § 194(a). Trusts must apportion the reforestation expenses between the trust and the beneficiaries on the basis of the trust income that is allocable to each. The expenses allocated to the beneficiaries qualify for either deduction or amortization.

Example 16.30 Reforestation Expense Deduction

Shaggy Bark Oake harvested timber from two tracts of uniquely identified land he owns as an individual investor. In 2011, he spent $13,000 on allowable reforestation expenses for the first tract and $8,000 on allowable reforestation expenses for the second tract. Because his costs for Tract 1 exceed the $10,000 limit, he also begins amortization of the $3,000 excess amount in 2011. For Tract 1, Shaggy's total cost recovery deduction is $10,214 [$10,000 + {($3,000 ÷ 84 months) × 6 months}], and for Tract 2 he may deduct the entire $8,000, for a total of $18,214.

Shaggy reports the $18,214 reforestation deduction on the dotted line next to line 36 of Form 1040, U.S. Individual Income Tax Return, with the label "RFST," and he includes it in the total of his adjustments to gross income reported on line 36.

Fertilizer Expense

The cost of fertilizer applied during reforestation of land used in the commercial production of timber can be deducted under I.R.C. § 194. Rev. Rul. 2004-62, 2004-25 I.R.B. 1, allowed a taxpayer in the timber business to deduct the cost of fertilizer applied after the trees were established as an ordinary and necessary expense under I.R.C § 162. Taxpayers who previously capitalized these costs must file IRS Form 3115, Change in Method of Accounting, to obtain automatic approval to change from capitalizing to deducting the fertilizer expense. Rev. Proc. 2008-52, 2008-36 I.R.B. 58, as modified by Rev. Proc. 2011-14 (Appendix § 3.04), 2011-4 I.R.B. 330, explains the procedure for requesting a change in method of accounting using Form 3115. The automatic change number for this change is 86.

Rev. Rul. 2004-62 does not address the treatment of post-establishment fertilizer expenses for timber investors. By analogy, investors could argue that the cost of fertilizer can be deducted under I.R.C. § 212(2) as an ordinary and necessary expense for the management of property held for production of income. If investors are not allowed to deduct the cost of fertilizer, they must add those costs to the basis of the timber and recover it as a depletion allowance when they sell timber.

Like-Kind Exchange of Timber and Timberland

Like kind is defined very broadly for purposes of an I.R.C. § 1031 exchange of real property. Any real estate held for investment or used in a trade or business can be exchanged for any other real estate that will be held for investment or used in a trade or business. For example, a tract of farmland held for use in a farming business and a rental beach condominium held as an investment are like-kind properties. An unimproved tract of land held for investment and a warehouse held for use in a construction business are also like kind.

Timberland

The presence or absence of timber on land does not affect its eligibility for a like-kind exchange with other real property. In Rev. Rul. 72-515, 1972-2 C.B. 466, the taxpayer exchanged land on which it had cut most of the merchantable timber for land that had substantial amounts of virgin timber. The IRS stated that "the timber growing on the timberland included in the exchange is a part of the property being exchanged. Such things as the quantity, quality, age, and species of the timber growing on the land may influence the grade or quality of the timberland involved in the exchange, but do not influence the kind or class of the property exchanged, that is, land." Therefore, the two properties were like kind.

In Rev. Rul. 76-253, 1976-2 C.B. 51, the taxpayer transferred all right, title, and interest in a tract of land except for timber-cutting rights to the land. In exchange, the taxpayer received all right, title, and interest in several other tracts of land. The IRS held that no gain was recognized on the exchange because the tracts were like kind. In Rev. Rul. 78-163, 1978-1 C.B. 257,the IRS allowed an exchange of timberland for bare land to qualify as a like-kind exchange by holding that the properties differed in "grade and quality," not in their "nature or character."

Example 16.31 Like-Kind Exchange of Timberland

Opp R. Tunity owned a service station in a resort location. Opp decided to sell his prime resort location to a developer that made a lucrative offer for it. To avoid recognizing gain on the sale, Opp located a large tract of timberland that was equal in value to the offer from the developer. Because the two properties are like kind, he negotiated a deferred like-kind exchange and rolled his gain from the resort property into the timberland.

Standing Timber

An exchange of real estate for standing timber or the right to cut standing timber may qualify as a like-kind exchange only if the interest in the standing timber is real property under state law. But the state law treatment may not be sufficient for the exchange to qualify for tax deferral under I.R.C. § 1031. The IRS and some courts also examine the duration of the right to the timber and hold that the right to cut timber for a limited duration is not like kind to an interest in real property.

The taxpayer in *Oregon Lumber Company v. Commissioner,* 20 T.C. 192 (1953), conveyed cut-over timberland in exchange for the right to cut timber of equal value in a national forest. The Tax Court looked to the applicable state law and concluded that the agreement to cut and remove timber from the land immediately or within a reasonable period of time (commonly 2 years) is an agreement for a sale of goods, which is personal property rather than real property under the applicable state law. Therefore, the conveyance of bare land for the right to cut standing timber was not a like-kind exchange. The court went on to say that even if the right to cut timber was an interest in real property, that interest and the bare land are not like kind because "the right to cut and remove standing timber is so intrinsically different from a fee in land that an exchange of one for the other is not an exchange of like property."

Technical Advice Memorandum

In a subsequent technical advice memorandum [T.A.M. 95-25-002 (February 23, 1995)], the IRS examined the duration of the right to cut timber to determine if that right and title to other real estate were like kind. The IRS distinguished *Commissioner v. Crichton,* 122 F.2d 181 (5th Cir. 1941), *aff'g* 42 B.T.A. 490 (1940), in which the Fifth Circuit held that the exchange of an overriding royalty interest in a mineral estate for a city lot qualified as a like-kind exchange; *Fleming v. Commissioner,* 24 T.C. 818 (1955), *aff'd* sub nom; and *P.G. Lake, Inc. v. Commissioner,* 356 U.S. 260 (1958), in which the Tax Court held that an assignment of carved-out oil payment rights and a fee interest in real estate were not like-kind properties although the applicable state law characterized the oil payment rights as an interest in real estate.

The IRS quoted the following from *Koch v. Commissioner,* 71 T.C. 54 (1978).

> The main distinction between the two transactions is the duration of the interests – an overriding royalty interest continues until the mineral deposit is exhausted whereas a carved-out oil payment right terminates usually when a

specified quantity of minerals has been produced or a stated amount of proceeds from the sale of minerals has been received.

The IRS concluded that the taxpayer's right to cut all trees growing on a tract of land for a 2-year period resembles the carved-out oil payment right more than the overriding royalty interest and held that the right to cut timber for a 2-year period and title to other real estate are not like kind.

Like-Kind Issue Unresolved

In *Smalley v. Commissioner,* 116 T.C. 450 (1994), the issue was whether the taxpayer had constructive receipt of a payment for purposes of the installment-sale rules. The taxpayer sold "the exclusive license and right to cut all merchantable pine and hardwood timber suitable for poles, saw timber, or pulpwood" on 95 acres of land. Under the terms of the sale contract, the buyer paid the purchase price to an escrow agent so that the taxpayer could complete a deferred like-kind exchange under I.R.C. § 1031.

The court held that if the taxpayer had a bona fide intent to complete a like-kind exchange, then he did not have constructive receipt of the payment to the escrow agent even if he did not acquire like-kind property within the replacement period.

The court did not undertake to resolve the legal issue of whether the like-kind requirement was satisfied, but it did analyze the like-kind exchange rules to determine whether the taxpayer could have believed in good faith that his transfer of the right to cut timber and a subsequent purchase of all rights to other land qualified as a deferred like-kind exchange.

The court concluded that it was reasonable for the taxpayer to believe that the proposed transaction would qualify as a like-kind exchange because under Georgia state law, the conveyance of standing timber to be severed by the buyer generally constitutes a transfer of real property. However, the court noted that "not every exchange of real property meets the section 1031 like-kind requirement."

By not ruling on the legal issue of whether the like-kind requirement was satisfied, the *Smalley* court leaves room for taxpayers to argue that an exchange of the right, title to, or interests in other real property are like kind if the right to cut timber is real property under the applicable state law.

ISSUE 9: WATER RIGHTS

Owners of water rights may find themselves in increasingly turbulent seas as the demand for water outstrips supply. This issue addresses the income tax issues that arise in water rights transactions.

Clean water supplies for five predominant uses—domestic, agricultural, municipal, industrial, and ecological (ecosystem preservation)—are increasingly under scrutiny by regulators from many governmental jurisdictions, watchdog groups, and environmentalists, as well as the users of water. Federal laws such as the Endangered Species Act affect rights to water and its use, and ownership of water rights varies by the jurisdiction in which the water is located.

Droplet of History

With the colonization of the United States came the implementation of water laws from several sources. English law was common among the original 13 colonies. Spanish law in Florida, California, Arizona, and New Mexico gave shape to early water law in those states; the Napoleonic Code was the basis of water law in Louisiana; and native Hawaiian law shaped water rights in Hawaii. Ultimately, English law became the foundation of federal law and state law in 49 of the 50 states. Louisiana retains its water law based on the Napoleonic Code.

International treaties and treaties with Native American tribes play a large role in shaping water rights. For example, recent litigation in Virginia involved treaties with four tribes that historically lived in the area and have fishing rights for migratory shad.

Riparian Rights

Riparian rights allow owners of land with frontage along streams, rivers, lakes, and oceans to use water from that body. This right to use water is not the actual ownership of water. In most riparian jurisdictions, the landowner may extract water for his or her domestic, agricultural, or commercial use but is limited to using an amount that is reasonable and that does not interfere with other riparian users downstream. Riparian rights are attached to the land contiguous to the water source and are generally not severable from the land.

The eastern states (generally defined as east of the Missouri River) had more water than their European settlers used, and riparian rights worked relatively well to allocate water among the uses. Today, some areas of the eastern United States have temporary water shortages. As the U.S. population continues to grow, control of water is likely to lead to more contentious legal battles. Therefore, water rights are likely to become more valuable over time, and markets for water rights may develop.

Prior Appropriation Rights

When the western states were settled, a new water right was recognized because water was often the limiting factor for successful commerce. The doctrine of *prior appropriation* (or *first-in-time is first-in-right*) provides that anyone putting water to a beneficial use (such as an agricultural, domestic, or fishery use) first owned that water right regardless of the source—contiguous or noncontiguous. These prior appropriation water rights are generally separate from the land from which the water comes and are treated as real estate interests.

Tax Issues

Acquiring and disposing of water rights raises the same income tax issues as acquiring or disposing of other property. Issues include tax basis, the character of gains and losses (capital or ordinary), whether the property is held for personal or business use, and whether the rights are real estate or personal property.

Tax Basis

As for any property, a taxpayer acquires an income tax basis in water rights in one or more of four ways—by purchase, gift, or inheritance, or through a nontaxable exchange.

Example 16.32 Purchase of Riparian Water Rights

Johnny Appleseed purchased a farm in an eastern state with a river as one of its boundaries. He intends to develop an apple orchard on the farm. Riparian rights to draw water from the river to irrigate the orchard are attached to the land. Because the riparian water rights may not be severed from the land, Johnny cannot allocate his purchase price separately to basis in the land and basis in the water rights.

Example 16.33 Purchase of Prior Appropriation Water Rights

Slippery Rock, who owns a cattle ranch, purchased a senior prior appropriated water right in the basin where his ranch is located. Slippery paid $100,000 for the water rights, $10,000 in attorney fees, and $2,000 in other acquisition costs. Slippery's basis in this water right is the $112,000 ($100,000 + $10,000 + $2,000) total cost.

Example 16.34 Allocation of Basis to Prior Appropriation Rights

Dusty Trail paid $2,500,000 (including transaction costs) for a ranch that has a building, fences, and senior and junior prior appropriated water rights. The appraised FMV of the separate assets totaled $2,440,000. Because the property did not constitute a business, no amount can be assigned to goodwill, so the full cost is assigned to each of the assets on a pro rata basis. Figure 16.28 shows the appraised FMV of each asset and the allocation of the purchase price based on those FMVs.

Practitioner Note Going Concern Value

Dusty could argue that there is going concern value in the acquisition of the land with the water rights. In that case, each asset would be assigned its FMV and the $60,000 excess purchase price would be amortizable over 180 months.

Figure 16.28 Dusty Trail's Purchase Price Allocation to Water Right

Asset	FMV	Purchase Price Allocation	Basis
Land	$ 2,000,000	$2,000,000 × ($2,500,000 ÷ $2,440,000)	$ 2,049,180
Building	140,000	$140,000 × ($2,500,000 ÷ $2,440,000)	143,443
Fences	90,000	$90,000 × ($2,500,000 ÷ $2,440,000)	92,213
Water rights	210,000	$210,000 × ($2,500,000 ÷ $2,440,000)	215,164
Total	$ 2,440,000		$ 2,500,000

Dusty can depreciate the bases of the building and fences. The bases of the land and the water rights are nondepreciable.

When property is acquired in a lump-sum purchase but then divided and sold off in parts, the cost basis of the property should generally be allocated over the several parts [*Gladden v. Commissioner,* 262 F.3d 851 (9th Cir. 2001)]. The *Gladden* court applied that rule to allow taxpayers to allocate part of the purchase price of land to water rights that were expected but not vested at the time the land was purchased. The court held that the premium paid for the land because of the expected water rights could be allocated to the basis of the water rights, to reduce the taxpayers' gain on sale of those rights.

In reaching that conclusion, the court noted that if the water rights had been vested when the land was purchased, there would be no question that Treas. Reg. § 1.61-6(a) would allow the taxpayers to allocate part of the purchase price to the water rights. The court also noted that if the land had been purchased with no expectation of acquiring water rights, none of the purchase price could be allocated to the water rights that were later sold.

Depletion

Taxpayers who own an economic interest in natural resources that are consumed (such as minerals, oil, gas, and timber) can deduct a depletion allowance. Generally, taxpayers cannot deduct a depletion allowance for water because the water is owned by the government for the public good. However, if a taxpayer acquires rights to a finite supply of water, such as the ground water source known as the Ogallala Formation aquifer, a depletion allowance may be allowed. Rev. Rul. 82-214, 1982-2 C.B. 115, allows taxpayers to use the cost method of depletion if the taxpayer can establish the basis and amount of water that existed at acquisition, establish that the water supply beneath the taxpayer's land during the tax year is exhausted, and show that once the water is extracted, it is lost to the taxpayer as well as to the immediately succeeding generation.

Taxpayers must also take into consideration on an annual basis the recharge to water to the aquifer before deducting the depletion allowance. Taxpayers cannot deduct a depletion allowance for a year in which the water level increases, and no further deduction for depletion is allowed until the water table again declines to a level below the previously known lowest level.

Under Rev. Proc. 66-11, 1966-1 C.B. 624, the basis of water rights for land in the Ogallala Formation is the difference in the value of land with a supply of ground water and land without a supply of ground water.

Example 16.35 Calculation of Depletion from the Ogallala Formation Aquifer

In 2008, M. T. Buckets paid $250,000 for farmland that includes a right to extract water from the Ogallala aquifer. An appraiser concluded that the FMV of similar land without the right to extract water is $150,000, which leaves $100,000 ($250,000 – $150,000) to be allocated to the basis of the right to extract water. The depletable saturated depth of the Ogallala aquifer on the date M. T. bought the land was 250 feet. Therefore, M. T.'s per foot basis is $400 ($100,000 ÷ 250 feet), and his depletion allowance for a tax year is $400 multiplied by the number of feet decrease in water level.

Figure 16.29 shows the change in the ground water level each year, as measured by the Ground Water District observation wells. It also shows M. T.'s depletion allowance for each year.

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Figure 16.29 M. T. Buckets's Ground Water Depletion Deductions

Year	Beginning Water Level (Feet)	Ending Water Level (Feet)	Decrease	Basis per Foot	Depletion Allowance
2008	250	230	20	$400	$8,000
2009	230	245	None	$400	None
2010	245	235	None[1]	$400	None
2011	235	225	5[2]	$400	$2,000

[1] Because the water level did not decrease below the previous 230-foot low, there is no decrease for depletion.
[2] The decrease for depletion is limited to the difference between the 225-foot ending level and the previous 230-foot low level.

For 2008 and 2011, M. T. can deduct his depletion allowance on line 32 of his Schedule F (Form 1040), Profit or Loss From Farming.

Sales of Water or Water Rights

The gain or loss from sales of water or water rights can be ordinary or capital, depending on how the sale is structured.

Capital Gain or Loss

For farmers and ranchers, the sale of water rights is generally treated as the sale of an asset used in a trade or business.

- If they held the water rights for more than a year, they report the sales in Part I of Form 4797, Sales of Business Property. The gain or loss is netted with other I.R.C. § 1231 gains or losses for the tax year. A net I.R.C. § 1231 gain is reduced by any unrecaptured I.R.C. § 1231 losses from the previous 5 years, and the balance is carried to Schedule D (Form 1040), Capital Gains and Losses, where it is netted with other capital gains and losses. A net I.R.C. § 1231 loss is treated as an ordinary loss.
- If farmers or ranchers hold water rights for 1 year or less, they report the sale in Part II of Form 4797, and the gain or loss is treated as an ordinary gain or loss.

Water rights are a capital asset for taxpayers who own land with water rights and hold it for personal, nonbusiness use [I.R.C. § 1221]. Taxpayers report the gain or loss from the sale of these water rights on Form 8949, Sales and Other Dispositions of Capital Assets, and then on Schedule D (Form 1040), Capital Gains and Losses.

Generally, gains or losses are recognized and reported in the year of the transaction. However, the sale of a water right is eligible for installment reporting if one or more payments is received in a year following the year of sale.

Cross-Reference Installment Sales

See the "Real Estate Issues" chapter in this book for an explanation of the installment-reporting rules.

Example 16.36 Water Right Used in Farming

Clemon Tyne operated a citrus orchard in the central valley of California. When he retired, he rented his land to a neighbor and sold his separable water right to her. Clemon paid $10,000 for the water right 45 years ago and sold it for $500,000, resulting in a $490,000 gain.

Because the water right was held for more than a year and used in the course of his citrus orchard business, it is treated as an I.R.C. § 1231 asset. Clemon reports his sale in Part I of Form 4797, where it is netted with his other I.R.C. § 1231 gains and losses.

Example 16.37 Water Right Attached to Personal-Use Property

Hustle Upp, a football coach, bought 100 acres of land that borders a river known to be good for fishing. When Hustle bought the property for $400,000 in February 2011 with a prior appropriation right to draw water from the river, he allocated 25% ($100,000) of the purchase price to the water right. Hustle bought the property for personal use and does not plan to develop the land, rent the land, or engage any business. In November 2011, the Division of Environment and Natural Resources (DENR) in his western state paid

Hustle $90,000 for his water right to maintain the river's flow and excellent fishing qualities.

Because the land and the water rights are personal-use property, Hustle's $10,000 ($100,000 – $90,000) loss is a nondeductible short-term capital loss.

Ordinary Income

If a taxpayer sells a right to use water and retains an economic interest in the water or leases water rights, the net income or loss is ordinary.

In *Vest v. Commissioner,* 481 F.2d 238 (5th Cir. 1973), the taxpayers sold the right to water under their property to an oil company. The court applied the retained economic interest rules for the sale of mineral interests and concluded that because the oil company's payments were dependent on the amount of water it used and the taxpayer also retained the right to use water, the taxpayers had a retained economic interest and the payments were ordinary income.

Example 16.38 Retained Economic Interest in Water Right

I. M. Wett owns a prior appropriation water right to the ground water under his property. I. M. agreed to sell water to NeedH$_2$O, Inc. for its local processing plant. NeedH$_2$O will pay I. M. $1,500 per 100,000 gallons of water withdrawn from pumps located on I. M.'s land. This agreement runs for an initial 30-year term, with a price adjustment every 5 years based on the 5-year average of the applicable Bureau of Labor Statistics Producer Price Index. The contract also grants NeedH$_2$O a right-of-way to access the pumps, pipelines, and storage tanks on I. M.'s property. The payments are ordinary income to I. M.

Income from sales of water in the ordinary course of business is subject to ordinary income tax rates as well as self-employment tax.

Example 16.39 Private Water Company

M. T. Bottles, Inc. owns the water right to a large freshwater spring in the mountains of Utah. M. T. Bottles sells water from the spring in two ways.

1. It delivers water to a housing development through a series of water distribution lines to each home.
2. It bottles water and sells it from route trucks and in grocery and convenience stores.

Because M. T. Bottles is in the business of selling water, its profit or loss is ordinary business income.

Like-Kind Exchanges

Water rights that are treated as an interest in property under state law qualify for a like-kind exchange with another interest in real property.

Because most of the western states treat prior appropriated water rights as real estate interests–either attached to but severable from land or as separate interests–those rights generally qualify for like-kind exchanges with other interests in real property under I.R.C. § 1031.

Riparian water rights in the eastern states are attached to the land and generally are not severable from the land. Therefore, riparian water rights can be exchanged only when the land to which they are attached is exchanged.

Abandonment

Taxpayers who live in jurisdictions where water rights are severable or separate real property may have a tax loss if the water right is abandoned. In several states, appropriated or permitted rights revert to the state for reappropriation if the water right is not used for a beneficial purpose (domestic, agricultural, municipal, or industrial) for a time period ranging from 2 to 10 years.

If the water right is a separate title and is abandoned, either through non-use or other means, the taxpayer may deduct the basis of the water right as an ordinary loss [Treas. Reg. § 1.165-2(b)].

If the water right attaches to land and is not a separate interest, the taxpayer does not realize a tax loss when the water right is abandoned. The abandonment may decrease the value of the property and reduce gain or increase loss on a subsequent sale of the property.

NOTES