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Selected Farm and Small Business Tax Issues

by

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SELECTED FARM AND SMALL BUSINESS TAX ISSUES

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I. OVERVIEW

The American Jobs Creation Act of 2004 ("AJCA") was signed into law on October 22, 2004.[1] The AJCA repealed the Extraterritorial Income Exclusion Act of 2000[2] ("ETI") and also enacted into law numerous other provisions of significance to farm and ranch taxpayers. The first part of this article addresses only those provisions of the bill that are of primary importance to agriculture. In the second part, it addresses recent tax developments of importance to agriculture.

II. AJCA CHANGES OF IMPORTANCE TO AGRICULTURE

A. *Repeal of ETI Exclusion and Enactment of New Deduction*

1. *In general*

The driving force behind the AJCA was pressure from the World Trade Organization ("WTO") to repeal the Extra-territorial Income Exclusion Act of 2000.[3] The 2000 Act had been labeled as "inconsistent with international trade agreements" by the WTO in early 2002.[4] The resultant AJCA legislation contained far more than a repeal of the 2000 ETI Act but also included a successor to the repealed legislation that has virtually nothing to do with international trade.[5]

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1. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (codified in scattered sections of 26 U.S.C.). *See* Neil E. Harl & Roger A. McEowen, *American Jobs Creation Act of 2004: A Summary of Selected Provisions*, 15 AGRIC. L. DIG., Oct. 29, 2004, at 161.

2. FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2423 (codified in scattered sections of 26 U.S.C.).

3. H.R. REP. No. 106-845, at 12 (2000).

4. *First in Series on the Extraterritorial Income Regime: Hearing Before the Subcomm. on Select Revenue Measures of the Committee on Ways and Means*, 107th Cong. (2002) (statement of Stephen D. Cifrulak, Jr.). *See also* WTO, *United States – Tax Treatment for "Foreign Sales Corporations": Recourse to Article 21.5 of the DSU by the European Communities*, WT/DS108/AB/RW, at 2 (Jan. 14, 2002), *available at* http://www.wto.org/english/tratop_e/dispu_e/108abrw_e.pdf [hereinafter WTO Report].

5. *See* I.R.C. § 199 (2005); American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (codified in scattered sections of 26 U.S.C.).

That provision, a deduction for "domestic production activities," is available to taxpayers with gross receipts derived from property that was "manufactured, produced, grown, or extracted" in the United States.[6]

AJCA repeals the ETI effective for transactions after December 31, 2004, subject to transitional rules for 2005 and 2006 and binding contracts in effect on September 17, 2003.[7] Although the legislation could be clearer, the Conference Committee Report confirms that the phase-out rule provides taxpayers with eighty percent of their otherwise applicable ETI benefits for transactions during 2005 and sixty percent of their otherwise applicable ETI benefits for transactions during 2006.[8]

2. *Details of the Extra-Territorial Income Exclusion Act of 2000*

The AJCA permits a portion of income from export products to be excluded through 2006.[9] Gross income does not include "extra-territorial income,"[10] defined as gross income of the taxpayer attributable to foreign trading gross receipts.[11] Under the 2000 Act, it appears that the exclusion can only be claimed if the commodity involved was actually exported outside the United States. Indeed (for farmers), temporary regulations issued under prior law took the position that "fungible export property" must be physically segregated from non-export property at all times to meet the foreign use, consumption, or disposition definition.[12] The term "foreign trading gross receipts" is defined as the gross receipts of the taxpayer which are:

> a. from the sale, exchange or other disposition of qualifying foreign trade property;
>
> b. from the lease of qualifying foreign trade property for use by the lessee outside the United States;
>
> c. for services related to such sale or lease;

6. I.R.C. § 199 (2005).
7. American Jobs Creation Act of 2004, 26 U.S.C. §§ 56, 114 (2005).
8. *See* H. R. CONF. REP. NO. 108-755, at 267, 108th Cong. (2004).
9. American Jobs Creation Act of 2004, 26 U.S.C. § 114 (2005).
10. I.R.C. § 114(a) (2004).
11. *Id.* § 114(e). *See* I.R.C. § 942 (2004).
12. *See* 26 C.F.R. § 1.927(a)-1T (d)(1)(i) (2004); I.R.C. § 114(e) (2005). *See also* I.R.C. § 942 (2004).

d. for engineering or architectural services for construction projects outside the United States; or

e. for the performance of managerial services in the production of foreign trading gross receipts.[13]

Qualifying foreign trade income for a transaction is the amount of gross income that, if excluded, would result in a reduction of taxable income equal to the greatest of:

a. thirty percent of the foreign sale and leasing income of the taxpayer from the transaction,

b. 1.2 percent of the foreign trading gross receipts of the taxpayer from the transaction, or

c. fifteen percent of the foreign trade income of the taxpayer from the transaction.[14]

The exclusion can be obtained without requiring an economic presence outside the United States (except for the thirty percent exclusion) so long as the taxpayer's foreign gross receipts do not exceed $5 million[15] and is claimed on Form 8873, "Extra-territorial Income Exclusion."[16]

3. *The 2004 Provision – A Deduction for Qualified Domestic Production Activities Income*

As mentioned above, the WTO ruled on January 14, 2002, that the ETI is inconsistent with international trade agreements.[17] Consequently, the ETI has been repealed, effective for transactions after December 31, 2004, subject to transitional rules.[18] It has essentially been replaced by an Internal Revenue Code ("I.R.C.") deduction authorized by AJCA ultimately equal to nine percent *of the*

13. I.R.C. § 942 (2004).

14. I.R.C. § 941(a)(1)(A)-(C) (2004). For agricultural or horticultural cooperatives, patronage dividends, or per-unit retain allocations allocable to qualifying foreign trade income in a written notice mailed to patrons are treated as qualifying foreign trade income of the patron, *see* I.R.C. § 943(g) (2004).

15. I.R.C. § 942(c)(1) (2004).

16. *See* I.R.S. Announcement 2003-47, 2003-29 I.R.B. 1 (Jul. 21, 2003), *available at* http://www.irs.gov/pub/irs-irbs/irb03-29.pdf.

17. WTO Report, *supra* note 4, at ¶ 256.

18. American Jobs Creation Act of 2004, 26 U.S.C. § 199 (2005).

lesser of—(1) the "qualified production activities income" of the taxpayer for the taxable year or (2) taxable income for the year.[19] This taxable income limitation excludes taxpayers with current year net operating losses ("NOL") or with NOL carryovers that eliminate current year taxable income.[20] For an individual, "adjusted gross income" is substituted for "taxable income." "Adjusted gross income" for individuals is determined:

1. after application of:
    a. I.R.C. § 86 (social security and Tier I Railroad Retirement Benefits),
    b. I.R.C. § 135 (income from United States Savings Bonds used to pay higher education tuition and fees),
    c. I.R.C. § 137 (adoption assistance),
    d. I.R.C. § 219 (retirement savings),
    e. I.R.C. § 221 (interest on education loans),
    f. I.R.C. § 222 (qualified tuition and related expenses), and
    g. I.R.C. § 469 (passive activity losses and credits);
2. and without regard to the deduction relating to income attributable to domestic production activities.[21]

The transition percentage is three percent of the term of the taxpayer's qualified production activities income for the taxable year in the taxpayer's taxable income for the year for 2005 and 2006 and six percent for 2007, 2008, and 2009, and nine percent after 2009.[22] The deduction cannot exceed fifty percent of the W-2 wages of the employer for the taxable year.[23]

The term "qualified production activities income" equals the taxpayer's domestic production gross receipts over the sum of the cost of goods sold, other expenses allocable to such receipts and a ratable portion of other deductions, expenses, and losses not directly allocable to such receipts.[24] The provision references some existing guidance for determining the proper allocation of costs and

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19. *Id.* at § 101. (emphasis added).
20. I.R.C. §§ 63, 172 (2004).
21. I.R.C. § 199(d)(2) (2005).
22. American Jobs Creation Act of 2004, 26 U.S.C. § 199 (2005).
23. I.R.C. §199(b) (2005). The term "W-2 wages" includes amounts required to be included on statements under I.R.C. § 6051(a)(3)-(8) (2005). That includes—(1) wages as defined in I.R.C. § 3401(a) (2005) (which does not include any remuneration other than cash for agricultural labor) and (2) elective deferrals (within the meaning of I.R.C. §§ 402(g)(3), 457 (2005)).
24. I.R.C. § 199(c) (2005).

expenses (e.g., I.R.C. § 263A rules in determining cost of goods sold and I.R.C. § 861 in determining other costs and expenses).[25]

A key part of the provision is the definition of "domestic production gross receipts" which includes gross receipts derived from:

> i. any lease, rental, license, sale, exchange or other disposition:
>
> I. of qualifying production property which was manufactured, *produced*, *grown*, or extracted by the taxpayer in whole or significant part within the United States;
>
> II. any qualified film produced by the taxpayer;
>
> III. electricity, natural gas or potable water produced by the taxpayer in the United States;
>
> ii. construction performed in the United States; or
>
> iii. engineering or architectural services performed in the United States for construction projects in the United States.[26]

Another key part of the legislation is the meaning of "in the United States." The Senate bill specifically provided that property would be treated as produced in "significant part" by the taxpayer within the United States if more than fifty percent of the aggregate development and production costs were incurred by the taxpayer in the United States.[27] That should pose little problem for agricultural producers. However, the House bill contained no such guidance, and the conference bill follows the House version.[28] What is clear is that the term specifically does not include the sale of food and beverages prepared by the tax-

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25. I.R.S. Notice 2005-14, 2005-7 I.R.B. 498, 505, § 3.04(2)-(3) (Feb. 14, 2005), *available at* http://www.irs.gov/pub/irs-irbs/irb05-07.pdf.

26. I.R.C. § 199(c)(4)(A) (2005) (emphasis added). Without question the key definitional terms, from an agricultural producer's perspective, are "produced and grown".

27. S. 1637, 108th Congress § 199(e)(2)(A) (2004).

28. As to electricity, the Conference Committee states:

> In the case of a taxpayer who owns a facility for the production of electricity, whether the taxpayer's facility is part of a regulated utility or an independent power facility, the taxpayer's gross receipts from the production of electricity at that facility are qualified domestic production gross receipts. However, to the extent that the taxpayer is an integrated producer that generates electricity and delivers electricity to end users any gross receipts properly attributable to the transmission of electricity from the generating facility to a point of local distribution and any gross receipts properly attributable to the distribution of electricity to final customers are not qualified domestic gross receipts.

150 CONG. REC. H. 8411, 8477 n. 28 (2004).

payer at a retail establishment and the transmission or distribution of electricity, natural gas, or potable water.[29] Likewise, the term does not include property leased, licensed, or rented by the taxpayer for use by a related person.[30]

The deduction is available to S corporations, partnerships, estates, trusts, and other pass-through entities as well as to individuals.[31] For pass-through entities, the wage limitation[32] is applied by allocating to the pass-through entity individual (such as a partner) the person's allocable share of W-2 wages or a portion of the qualified production activities income allocated to that person for the taxable year.[33]

Deductions are allowed to cooperatives engaged in manufacturing, production, growth, or extraction and to cooperatives engaged in the marketing of agricultural or horticultural products.[34] The new deduction is allowed for alternative minimum tax purposes. Procedurally, the provision allows for the qualified production activities income deduction for purposes of computing minimum taxable income (including adjusted current earnings). The AMT deduction is determined by reference to the lesser of the qualified production activities income (as determined for the regular tax) or the alternative minimum taxable income without regard to the deduction.[35]

4. *IRS Guidance*

a. *Notice 2005-14 and the "Trade or Business" Requirement*

In February 2005, the IRS issued an interim guidance on key provisions of the domestic production deduction and announced that the IRS and the Treasury Department are developing regulations regarding the deduction.[36] The interim guidance provides some assistance in planning for the deduction, first claimable on 2005 returns, but leaves several major concerns unresolved.

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29. H.R. CONF. REP. NO. 108-755, at n. 26 (2004).
30. I.R.C. § 199(c)(7)(A) (2005).
31. *Id.* § 199(d)(1)-(2).
32. *See id.* § 199(b).
33. *Id.* § 199(d)(1)(B).
34. *Id.* § 199(d)(3).
35. *Id.* § 199(d)(6).
36. I.R.S. Notice 2005-14, 2005-7 I.R.B. 498 (Feb 14, 2005), *available at* http://www.irs.gov/pub/irs-irbs/irb05-07.pdf. *See also* Neil E. Harl, *Guidance on New Domestic Production Deduction*, 16 AGRIC. L. DIG., Feb. 25, 2005, at 25.

As indicated above, the term "qualified production activities income" equals the taxpayer's "domestic production gross receipts" over the sum of the cost of goods sold, other expenses allocable to such receipts and a ratable portion of other expenses and losses not directly allocable to such receipts.[37] Domestic production gross receipts includes gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of qualifying production property that was "manufactured, produced, grown, or extracted" by the taxpayer in whole or in significant part within the United States.[38] The provision makes specific reference to several areas of economic activity including the generation of electricity, construction performed, and engineering or architectural services performed in the United States.[39] The statute specifically provides that "this section shall be applied by only taking into account items which are attributable to the actual conduct of a trade or business."[40] The interim guidance mirrors the statute in identical language.[41] That likely creates problems for farm landlords who are not materially participating under a lease.[42]

b. *Which Test for "Trade or Business" Applies?*

Unfortunately, neither the statute nor the interim guidance indicates which meaning of "trade or business" is to be used in implementing the provision.[43] Several different definitions of the term "trade or business" are in use. The least demanding is the meaning of the term for purposes of income averaging for farmers and fishermen.[44] For purposes of that provision, rental income under a share-rent lease is treated as income from a farming business, where a requirement of eligibility for income averaging is that the individual be "engaged

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37. I.R.C. § 199(c)(1) (2005).

38. *Id.* § 199(c)(4).

39. *Id.* § 199(c)(4)(A)(i). The deduction is allowed for alternative minimum tax purposes and is available for pass through entities and cooperatives as well as for individual taxpayers. *See* I.R.C. §§ 199(b), 199(d)(1)(B), 199(d)(2), 199(d)(3) (2005).

40. I.R.C. § 199(d)(5) (2005).

41. *See* I.R.S. Notice 2005-14, 2005-7 I.R.B. 503, § 2.07, *available at* http://www.irs.gov/pub/irs-irbs/irb05-07.pdf. *Compare* American Jobs Creation Act of 2004, 26 U.S.C. § 199, *with* I.R.C. § 199(d)(5) (2005).

42. *See* I.R.C. § 1402(a)(1) (2004) (stating that rentals are excluded unless such rentals are received in the course of a trade or business as a real estate dealer).

43. *See* I.R.C. § 199(d)(5) (2005); I.R.S. Notice 2005-14, 2005-7 I.R.B. 503, § 2.07 *available at* http://www.irs.gov/pub/irs-irbs/irb05-07.pdf.

44. *See* I.R.C. § 1301 (2004).

in a farming business."[45] Whether the landlord is participating in the operation is immaterial.[46] Thus, a non-materially participating share-rent landlord appears to be eligible.[47]

A slightly tougher test is utilized for purposes of expense method depreciation.[48] Under this test, the taxpayer must "meaningfully participate" in the management or operation of the trade or business.[49] The regulations make the point that it is a facts and circumstances test.[50]

The standard test, which is utilized for self-employment tax[51] and special use valuation[52] purposes as well as the test for recapture under the family-owned business deduction provision,[53] is the well-known test of "material participation." That test is not met by non-materially participating farm landlords, who normally file on Form 4835 rather than Schedule F.[54]

Finally, a more demanding meaning of the term "material participation" was imposed in 1986 for purposes of determining whether an activity is considered a passive activity under the passive loss rules.[55] That meaning of the term requires that the taxpayer be involved in the activity on a basis which is "(A) regular, (B) continuous, and (C) substantial."[56]

Thus, for non-materially participating landlords, including those in retirement and those who are disabled as well as those who simply choose not to be substantially involved in the farming operation under the lease, the question of which meaning of the term "trade or business" is imposed on the provision authorizing the new deduction takes on great importance.[57] Hopefully, the IRS will

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45. *Id.* § 1301(a).

46. Treas. Reg. § 1.1301-1(b)(2) (2004).

47. *See id.*

48. I.R.C. § 179 (2004).

49. Treas. Reg. § 1.179-2(c)(6)(ii) (2004).

50. *Id.*

51. I.R.C. § 1402 (2004).

52. I.R.C. § 2032A (2004). The term "active management" was created by Congress in 1981, which substitutes for material participation in the case of surviving spouses who acquire real property from a deceased spouse for purposes of special use valuation. *Id.* § 2032A(b)(5).

53. I.R.C. §§ 2057(b)(1)(D)(ii), 2057(f)(1)(A) (2005).

54. *See* Estate of Heffley v. Comm'r, 89 T.C. 265, 269 (1987). It should also be noted that the provision imposing the standard "material participation" test also contains a bar on imputation of activities of an agent such as a farm manager to the land owner. *See* I.R.C. § 1402(a)(1) (2004).

55. I.R.C. § 469(c)(1).

56. *Id.* § 469(h)(1).

57. I.R.C. § 199 (2005).

resolve the issue in the near future. Otherwise, non-material participation landlords could be faced with a three to nine percent "tax" on the decision to operate under a non-material participation share lease.

B. *Livestock Sold Because of Weather-Related Conditions*

1. *Involuntary Conversion Treatment.*

If a farmer sells livestock (other than poultry) held for draft, dairy, or breeding purposes in excess of the number that would normally be sold during that time period, the sale or exchange of the excess number is treated as an involuntary conversion if the sale occurs on account of drought or other weather-related condition.[58] Although it is not necessary for the livestock to have been held in the area, the sale must have been solely on account of weather-related conditions, the existence of which affected the water, grazing, or other requirements of the livestock so as to necessitate their sale.[59]

The number of animals that may qualify for involuntary conversion treatment is limited to the excess over the number that would have been sold or exchanged under usual business practices.[60] The livestock sold or exchanged must be replaced within the replacement period with livestock similar or related in service or use to the livestock sold or exchanged because of the weather-related condition. The new livestock must be held for the same purpose as the animals disposed of because of the weather-related condition.[61] The replacement period was two years after the year in which the proceeds were received through 2002,[62] but AJCA extended the replacement period to four years effective for taxable years with respect to which the due date (without regard to extensions) for the return is after December 31, 2002.[63] Also, under AJCA, the Secretary of the Treasury is given authority to extend, on a regional basis, the replacement period if the weather-related conditions continue for more than three years.[64] The holding period for the animals sold or exchanged can be added to the holding

58. I.R.C. § 1033(e) (2004).

59. Treas. Reg. § 1.1033(e)-1(b). Legislation has been introduced to extend I.R.C. § 1033(e) to federal land management agency actions. S. 2762, 107th Cong. § 1 (2002).

60. Treas. Reg. § 1.1033(e)-1(c) (2004).

61. *Id.* § 1.1033(e)-1(d).

62. *See* I.R.C. §§ 451(e)(3), 1033(e) (2004).

63. *See* American Jobs Creation Act of 2004, 26 U.S.C. § 1033(e) (2005).

64. *See id.* at § 1033(e)(2).

period of the acquired animals if the basis is determined by reference to the basis of the animals sold or exchanged.[65]

All of the details of the disposition of the livestock are to be reported on the return for the taxable year when proceeds are received.[66] The taxpayer is to include evidence of the existence of weather conditions which forced the disposition of the livestock, a computation of the gain involved, the number and kind of livestock sold or exchanged, and the number that would have been sold or exchanged under usual business practices in the absence of weather-related conditions.[67] Apparently, I.R.C. § 1033(e) treatment can be elected on an amended return. Extensions can be requested if the property cannot be replaced within the allowed time.[68]

As noted above, AJCA extends from two years to four years the period for reinvestment of the proceeds from sale of livestock held for draft, dairy, or breeding purposes because of weather-related conditions if the area has been designated as eligible for assistance by the federal government. It appears that the requirement of federal designation applies only to reinvestment beyond the two-year period.[69]

AJCA also expands the provision on sale because of environmental contamination (I.R.C. § 1033(f)) to apply also to sale of eligible livestock because of weather-related conditions where it is not feasible for the taxpayer to reinvest the proceeds in property similar or related in use.[70] The proceeds can be reinvested in "other property . . . used for farming purposes" except for investment in real property which is reserved for soil contamination or other environmental contamination.[71] However, if livestock are replaced with "other property ... used for farming purposes" in accordance with the 2004 amendment), the replacement period in two years (and not four).[72]

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65. *See* I.R.C. § 1223(1)(A) (2004).

66. Treas. Reg. § 1.1033(a)-2(c)(2) (2004).

67. *Id.* § 1.1033(e)-1(e). The details of the disposition should be provided via an attachment to the return.

68. *See id.* § 1.1033(a)-2(c)(3) (noting additional time available for "reasonable cause").

69. *See* American Jobs Creation Act of 2004, 26 U.S.C. § 1033 (2005) (amending I.R.C. § 1033(e) (2004)).

70. *See id.* at § 1033(f).

71. I.R.C. § 1033(f) (2005).

72. *Id.*

2. *One-Year Deferral Provision*

Under a separate provision, farm and ranch taxpayers on the cash method of accounting who are forced to dispose of livestock due to drought or other weather-related conditions, are able to defer reporting the gain until the following taxable year.[73] To be eligible for deferral, the taxpayer's principal business must be farming.[74]

The drought (or other weather-related condition) must have resulted in the farmer's area being designated for assistance by the federal government.[75] The livestock need not be raised or sold in a drought or weather-related area; however, the sale must occur solely on account of conditions in the designated area "which affected the water, grazing, or other requirements of the livestock so as to necessitate the sale."[76] The livestock may be sold prior to the disaster designation so long as the sale is attributed to the disaster.[77] Any designation of assistance by a federal agency is acceptable for this purpose, including FSA or SBA.[78] In addition, the taxpayer must establish that, under the taxpayer's usual business practice, the sale or exchange would not have occurred but for the weather conditions; and the conditions must have resulted in the area being designated for assistance by the federal government.[79]

Deferral of income is limited to sales in excess of "usual business practices" and, through December 31, 1987, did not apply to livestock held for draft, dairy, breeding, or sporting purposes.[80] After 1987, draft, dairy, breeding, or sporting purpose livestock are eligible.[81] The election is made by attaching a statement to the income tax return or an amended return for the year in which the early sale of livestock occurs and, until the AJCA provision became effective,

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73. I.R.C. § 451(e)(1) (2004).

74. I.R.C. § 451(e)(2). *See* Priv. Ltr. Rul. 89-28-050 (Apr. 18, 1989) (discussing rancher grossing average of $121,000 per year and earning $65,000 per year in full-time off-farm job eligible where taxpayer devoted 750-1000 hours per year to ranch and spouse contributed about 300 hours and held that taxpayer's principal trade or business deemed to be farming).

75. Treas. Reg. § 1.451-7(a) (2004).

76. I.R.S. Notice 89-55, 1989-1 Cumulative Bulletin 696.

77. *Id.*

78. *Id.* Legislation has been introduced to extend I.R.C. § 451(e) to federal land management agency actions. S. 2762, 107th Cong. § 1 (2002).

79. *See* Treas. Reg. § 1.451-7(a) to (c) (2004).

80. I.R.C. § 451(e). *See* Treas. Reg. § 1.451-7(a) (2004).

81. Technical and Miscellaneous Revenue Act of 1988, § 6030, Pub. L. No. 100-647, 102 Stat. 3342, 3694 (amending I.R.C. § 451(e)).

had to be *made within the time for filing the return including extensions.*[82] Therefore, this election could not be elected on a late-filed return. The election must contain:

a. a declaration that an election is being made;
b. evidence of the existence of weather-related conditions which forced the early sale or exchange of the livestock and the date, if known, on which the area was designated as eligible for federal assistance as a result of the conditions. The sale can occur before designation;[83]
c. a statement explaining the relationship of the area to the taxpayer's early sale or exchange of the livestock;
d. the total number of animals sold in each of the three preceding years;
e. the number of animals which would have been sold in the taxable year had the taxpayer followed its normal business practice;
f. the total number of animals sold and the number sold on account of weather-related conditions during the taxable year; and
g. a computation of the amount of income to be deferred.[84]

To arrive at the amount of income deferred, the total amount of income from the sale or exchange of livestock in a classification during the taxable year is to be divided by the total number of all livestock sold in that classification.[85] The result is then multiplied by the excess number of livestock sold on account of weather in that classification.[86]

A taxpayer who has made an election to defer the taxation of gain from the sale of livestock because of weather-related conditions has been allowed to later revoke the election and make an election with the consent of the Commissioner to defer income by reinvestment under I.R.C. § 1033(e).[87] To revoke, it may be necessary to file a letter ruling request or request a determination letter from the District Director. The National Office does not issue letter rulings on the replacement of involuntarily converted property, whether or not the property

82. Treas. Reg. § 1.451-7(g) (2004). (emphasis added).
83. Rev. Rul. 89-55, 1989-1 Cumulative Bulletin 696.
84. Treas. Reg. § 1.451-7(g) (2004).
85. *Id.* § 1.451-7(e)(1).
86. *Id.* § 1.451-7(g).
87. *See* Priv. Ltr. Rul. 93-32-032 (Aug. 13, 1993); Priv. Ltr. Rul. 92-14-021 (April 3, 1992); Priv. Ltr. Rul. 9127012 (June 5, 1991) (discussing whether sale of livestock is involuntary conversion left to IRS District Office).

has been replaced, if the taxpayer has already filed a return for the tax year in which the property was converted.[88] The District Director may issue a determination letter in such a situation.[89]

AJCA amended the provision applicable to the one-year deferral for sale or exchange of livestock because of weather-related conditions to state that an election is valid if made during the replacement period for livestock under I.R.C. § 1033(e) if it applies to a sale or exchange of livestock. That means the election can be made within the four-year period.[90] As mentioned above, the AJCA amendments to the livestock sale apply to any taxable year with respect to which the due date (without regard to extensions) for the return is after December 31, 2002.[91]

C. *Start-Up Expenses and Organizational Expenditures*

AJCA specifies that for amounts paid or incurred after October 22, 2004, a taxpayer is allowed to elect to deduct up to $5000 of start-up expenses and $5000 of organizational expenditures in the taxable year the trade or business begins.[92] Each $5000 is reduced (but not below zero) by the amount the cumulative cost of start-up or organizational expenses exceed $50,000, respectively.[93] Excess start-up and organizational expenditures are amortized over fifteen years.[94] The amendments eliminate sixty-month amortization for both start-up expenses and organizational expenditures.[95]

D. *Sale of Principal Residence within Five Years of Sale*

AJCA denies the I.R.C. § 121 exclusion to property acquired in a like-kind exchange within the prior five-year period beginning with the date of property acquisition. The provision is designed to counter situations where: (1) the property is exchanged for residential real property, tax free, under I.R.C. § 1031;

88. Rev. Proc. 93-1, 1993-1 Cumulative Bulletin 320.
89. Rev. Proc. 93-1, 1993-1 Cumulative Bulletin 323.
90. American Jobs Creation Act of 2004, 26 U.S.C. § 451 (2005).
91. *Id.*
92. I.R.C. §§ 195(b)(1), 248(a) (2005).
93. *Id.* §§ 195(b)(1)(A)(ii), 248(a)(1)(B).
94. *Id.* §§ 195(b)(1)(B), 248(a)(2).
95. American Jobs Creation Act of 2004, 26 U.S.C. § 195 (2005).

(2) the property is converted to personal use; and (3) a tax-free sale is arranged under I.R.C. § 121.[96]

E. *Donations of Motor Vehicles, Boats and Airplanes*

AJCA imposes limits on donated property, such as used automobiles (but also including boats and airplanes) with a claimed value in excess of $500. The AJCA requires contemporaneous substantiation of value and provides that sale of the property by the donee (without improvements or significant intervening use) limits the charitable deduction to the gross proceeds received from the sale.[97]

F. *Income Averaging and AMT*

AJCA provides that, in computing alternative minimum tax, the regular tax liability for farmers and fishermen is determined without regard to income averaging.[98] Thus, a farmer receives the full benefit of income averaging. The Act also extends income averaging to fishermen.[99]

G. *Handling Attorneys' Fees in Recoveries from Settlements*

1. *Split Among Circuit Courts of Appeal*

Although the issue has been controversial since the decision in *Cotnam v. Commissioner*,[100] the handling of settlements and court judgment recoveries has been a matter of major concern only in the last decade.[101] The issue is whether legal fees paid to the taxpayer's attorneys are excludable from the recovery or whether the entire recovery must be included in the taxpayer's income, with the attorney's fee treated as a miscellaneous itemized deduction subject to the two

96. *See id.* at § 121(d).

97. *Id.* at § 170. The provision is effective for contributions made after December 31, 2004.

98. *See* I.R.C. § 55(c) (2005). *See also* I.R.C. § 1301(a) (beginning those taxable years after December 31, 2003).

99. *Id.* § I.R.C. § 55 (c).

100. Cotnam v. Comm'r, 263 F.2d 119 (5th Cir. 1959).

101. *See, e.g.*, Estate of Clarks v. United States, 202 F.3d 854 (6th Cir. 2000) (holding that contingency fees are property of attorney and are not taxable to client); Alexander v. IRS, 72 F.3d 938 (1st Cir. 1995) (holding that it is acceptable to include legal fees in taxpayer's income).

percent floor[102] which often triggers alternative minimum tax.[103] The Federal Circuit Courts of Appeal have been divided deeply on the issue, with the First, Second, Seventh, Ninth, Tenth, and the Federal Circuit Courts of Appeal holding that the portion of an attorney's contingency fee paid to the attorney must be included in the taxpayer's income.[104] However, the Fifth, Sixth, and Eleventh Cir-

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102. I.R.C. § 67(a) (2004). *See* Kenseth v. Comm'r, 114 T.C. 399 (2000), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

103. *See* I.R.C. §§ 56(b)(1)(A)(i), 67(b) (2004).

104. *Kenseth*, 114 T.C. 399 (holding that contingency fees were includable in taxpayer's gross income with attorneys' fees deductible as miscellaneous itemized deductions subject to two percent floor. The *Clarks* and *Cotnam* cases were not followed); Priv. Ltr. Rul. 98-09-053 (Feb. 27, 1998) (holding that fees paid pursuant to a settlement in a gender and age discrimination case are includable in gross income). *See* Benci-Woodward v. Comm'r, 219 F.3d 941 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001) (holding that a portion of punitive damage award retained by attorneys are includable in taxpayer's income; under California law, attorney's lien does not confer ownership interest); Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995) (holding that the fact that attorney received contingency fee directly from court in condemnation proceeding and had statutory lien on proceeds under state law did not render amount of attorney fees excludable from partnership's gross income); Alexander v. IRS, 72 F.3d 938 (1st Cir. 1995) (holding that legal fees incurred in action against former employer for breach of contract could not be offset against settlement proceeds, and settlement proceeds are entirely includable as ordinary income in taxpayer's gross income); Raymond v. United States, 247 F. Supp. 2d 548 (D. Vt. 2002), *rev'd*, 355 F.3d 107 (2d Cir. 2004), *on remand*, 04-1 U.S.T.C. ¶ 50,215 (D. Vt. 2004) (holding that wrongful termination recovery required to be included in income to extent paid to attorneys as contingent fee); Hukkanen-Campbell v. Comm'r, 79 T.C.M. (CCH) 2122 (2000), *aff'd*, 274 F.3d 1312 (10th Cir. 2001) (holding that contingency fee portion of settlement taxed to individual); Coady v. Comm'r, 76 T.C.M. (CCH) 257 (1998), *aff'd*, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001) (holding that fees under contingency fee agreement not excludable from gross income in a wrongful termination suit; court rejected argument that attorney had a property interest in the action); Sinyard v. Comm'r, 76 T.C.M. (CCH) 654 (1998), *aff'd*, 268 F.3d 756 (9th Cir. 2001), *cert. denied*, 536 U.S. 904 (2002) (discussing age discrimination suit and full amount constructively received and taxable to client). *See also* Biehl v. Comm'r, 118 T.C. 467 (2002), *aff'd*, 351 F.3d 982 (9th Cir. 2003) (holding that fee paid to attorney as part of settlement agreement of wrongful termination claim not excludable from incomeand treated as miscellaneous itemized deduction subject to two percent floor); Reynolds v. Comm'r, 02-2 U.S.T.C. ¶ 50,525 (7th Cir. 2002) (holding that legal defense expenditures subject to two percent floor); Brewer v. Comm'r, 99-1 U.S.T.C. ¶ 50,378 (9th Cir. 1999) (holding that amount paid directly to attorney as legal fees not excludable from income); Freeman v. Comm'r, 82 T.C.M. (CCH) 643 (2001), *aff'd*, 03-1 U.S.T.C. ¶ 50,335 (9th Cir. 2003) (holding that attorneys' fees included in income but eligible for miscellaneous deduction); Gale v. Comm'r, 83 T.C.M. (CCH) 1270 (2002) (holding that settlement proceeds paid to taxpayer's attorney taxable to taxpayer even though funds not paid to taxpayer; legal fees deductible); Brenner v. Comm'r, 81 T.C.M. (CCH) 1687 (2001) (holding that legal fees for terminated employee in settlement of claims were miscellaneous itemized deductions and includable in calculating alternative minimum tax); Murray v. Comm'r, T.C. Summ. Op. 2004-60 (2004).

cuit Courts of Appeal (and the Tax Court) have allowed the portion of an attorney's contingency fee paid to the attorney to be excludable from income.[105] The theories for excluding attorney's fees are based on the argument that contingency fees are property of the attorney and are bolstered by state law providing a lien, including a common law lien, under state law.[106]

2. *Partial Statutory Solution*

For fees and costs paid after October 22, 2004, with respect to a judgment or settlement occurring after that date, AJCA of 2004 provides for a deduction for attorneys fees and other costs associated with discrimination in employment or enforcement of civil rights.[107] The Act allows an above-the-line deduction for amounts attributable to attorney fees and costs received by individuals on account of claims of unlawful discrimination or specified claims against the government.[108] The identified claims against the government are those brought under the False Claims Act.[109] Regarding employment discrimination, the new law identifies the types of qualifying "unlawful discrimination" by reference to a long laundry list of laws that provide for employment claims.[110] Specifically enumerated are:

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105. Banks v. Comm'r, 345 F.3d 373 (6th Cir. 2003) *cert. granted*, 541 U.S. 958 (U.S. 2004); Banaitis v. Comm'r, 340 F.3d 1074 (9th Cir. 2003), *cert. granted*, 541 U.S. 958 (U.S. 2004); *In re* Estate of Clarks, 202 F.3d 854 (6th Cir. 2000) (holding that contingency fees are property of attorney and are therefore not taxable to client); Srivastava v. Comm'r, 220 F.3d 353 (5th Cir. 2000) (holding that the attorney had common law lien under Texas law); Cotnam v. Comm'r, 263 F.2d 119 (5th Cir. 1959); Griffin v. Comm'r, 81 T.C.M. (CCH) 972 (2001) (*Cotnam*, 263 F.2d 119, was followed); Davis v. Comm'r, 76 T.C.M. (CCH) 46 (1998), *aff'd*, 210 F.3d 1346 (11th Cir. 2000) (noting that *Cotnam*, 263 F.2d 119, was followed and involved same jurisdiction); Brisco v. United States, 9 Fed. Appx. 375 (6th Cir. 2001) (holding in a personal injury claim that interest earned on attorney's contingency fee could be excluded from income). The IRS has ruled that the entire settlement had to be included in income with the attorney fees deductible as trade or business expenses. Priv. Ltr. Rul. 200203010 (Jan. 18, 2002) (attorney fees not itemized deduction, but trade or business deduction so not subject to alternative minimum tax). The decision in *Cotnam* has been criticized. Foster v. United States, 106 F. Supp. 2d 1234, 1239 (N.D. Ala. 2000), *aff'd on point*, 249 F.3d 1275 (11th Cir. 2001) (stating that there are "serious and legitimate questions as to whether the holding in *Cotnam* should continue to be followed").

106. *See, e.g.*, Srivastava v. Comm'r, 76 T.C.M. (CCH) 638 (1998), *rev'd*, 220 F.3d 353 (5th Cir. 2000) (discussing common law lien under Texas law).

107. American Jobs Creation Act of 2004, 26 U.S.C. § 62 (2005).

108. *Id.*

109. *Id.* § 62 (a)(19) (citing 31 USC § 3730 (2003)).

110. *Id.* § 62 (e).

a. The Civil Rights Act of 1991;
b. The Congressional Accountability Act of 1955;
c. The National Labor Relations Act;
d. The Fair Labor Standards Act of 1938;
e. The Age Discrimination in Employment Act of 1967;
f. The Rehabilitation Act of 1973;
g. The Employee Retirement Income Security Act of 1974;
h. The Education Amendments of 1972;
i. The Employee Polygraph Protection Act of 1988;
j. The Worker Adjustment and Retraining Notification Act;
k. The Family and Medical Leave Act of 1993;
l. Chapter 43 of Title 38 (relating to employment and reemployment rights of members of the uniformed services);
m. Sections 1981, 1983, and 1985 cases;
n. The Civil Rights of Act of 1964;
o. The Fair Housing Act;
p. The Americans With Disabilities Act of 1990;
q. any provision of federal law (popularly known as whistleblower protection provisions) prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under federal law; or
r. any provision of federal, state, or local law, or common law claims permitted under federal, state, or local law, providing for the enforcement of civil rights or regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.[111]

Because it is an above-the-line deduction, the attorney's fees and costs are no longer subject to the reduction in itemized deductions for high income individuals and can be claimed for alternative minimum tax purposes.[112] The above-the-line deduction is limited to the amount includable in the individual's

111. *Id.*
112. *Id.*

gross income for the tax year on account of a judgment or settlement resulting from the claim.[113]

3. *Supreme Court Guidance*

On January 24, 2005, the U.S. Supreme Court settled the dispute among the Circuit Courts of Appeal by holding that attorney fees are included in the taxpayer's income under the assignment of income doctrine.[114] The case involved a consolidation of cases from the Ninth Circuit and Sixth Circuit. In the Ninth Circuit case, the taxpayer had been employed as a loan officer in a bank but was forced to leave upon refusing to divulge confidential information about clients.[115] The taxpayer sued the bank for intentional interference with contract and economic expectations for wrongful discharge from employment.[116] The parties eventually reached a settlement which included punitive damages and payment directly to the taxpayer's attorneys.[117] The taxpayer argued that the compensatory damages, the portion of the settlement paid to the attorneys and the punitive damages were excludable from income.[118] The Tax Court acknowledged that the taxpayer's lawsuit was based on tort law, but the court held that the settlement proceeds and punitive damages were included in income because the tort was not based on personal injuries.[119] Although acknowledging a split of authority on the issue, the Tax Court also held that the settlement proceeds paid directly to the taxpayer's attorney were included in income.[120] On appeal, the Ninth Circuit affirmed on the issue of the settlement proceeds paid to the taxpayer, but reversed on the issue of the taxability of the attorneys' fee portion of the settlement. The court held that, under Oregon law, the attorneys had sufficient property rights in the fees to remove them from the taxpayer's taxable income.[121]

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113. *Id.* § 62 (a)(19).

114. Comm'r v. Banks, 125 S. Ct. 826, 834 (2005).

115. Banaitis v. Comm'r, 340 F.3d 1074, 1076 (9th Cir. 2003), *rev'd sub nom.* Banks, 125 S. Ct. 826.

116. *Banaitis*, 340 F.3d at 1077.

117. *Id.*

118. *Id.* at 1078.

119. *See* Banaitis v. Comm'r, 83 T.C.M. (CCH) 1053 (2002), *aff'd in part and rev'd in part*, 340 F.3d 1074, 1076 (9th Cir. 2003), *rev'd sub nom. Banks*, 125 S. Ct. 826.

120. *Id.*

121. *Banaitis*, 340 F.3d at 1083.

In the Sixth Circuit case, the taxpayer sued a former employer for race discrimination in termination of employment. [122] The suit asked only for back pay and attorneys' fees as damages.[123] The parties reached a settlement which characterized the payments as for personal injury to the taxpayer. The Tax Court held that the character of the settlement proceeds was determined by the pending claims made in the lawsuit. [124] Consequently, the settlement proceeds were for back pay and attorneys' fees with the result that the amounts were included in the taxpayer's income. The Sixth Circuit affirmed on the issue of whether the settlement proceeds were included in the taxpayer's income, but reversed on the issue of the attorneys' fees, which were excluded from income because the contingency fee agreement removed the fees from the taxpayer's control. [125]

As noted above, the U.S. Supreme Court held that attorney contingent fees were included in both taxpayers' incomes under the assignment of income doctrine.[126]

III. OTHER RECENT DEVELOPMENTS OF SIGNIFICANCE TO AGRICULTURE

A. *Self-Employment Tax*

A tax is imposed on the self-employment income of every individual. Self-employment income is defined as "net earnings from self-employment."[127] The term "net earnings from self-employment" is defined as gross income derived by an individual from a trade or business that the individual conducts.[128] Under a statutory exception, income derived from real estate rents is not subject to self-employment tax unless the arrangement involves an agreement between a

122. Banks v. Comm'r, 345 F.3d 373, 375 (6th Cir. 2003).

123. *Id.* at 376.

124. Banks v. Comm'r, 81 T.C.M. (CCH) 1219 (2001).

125. *Banks*, 345 F.3d at 389.

126. *See* Banks v. Comm'r, 125 S. Ct. 826, 832 (2005). Under the American Jobs Creation Act of 2004, for fees and costs paid after October 22, 2004, with respect to a judgment or settlement occurring after that date, a deduction is allowed for attorney's fees and other costs associated with actions involving discrimination in employment or enforcement of civil rights. American Jobs Creation Act of 2004, 26 U.S.C. § 62 (2005). In addition to providing relief only prospectively, the 2004 legislation necessarily excludes some types of recoveries where the problem of deductibility as a miscellaneous itemized deduction exists.

127. I.R.C. § 1402(b) (2004).

128. *Id.* The IRS has insisted that income from a spring heifer or bull sale is subject to self-employment tax. *See* Hillman v. United States, 2002-2 U.S.T.C (CCH) ¶ 50,700 (2002) (noting heifers sold as "top of the breed").

landowner or tenant and another party providing for the production of an agricultural commodity and the landowner or tenant materially participates.[129] For rental situations not involving the production of agricultural commodities where the taxpayer materially participates, rental income is subject to self-employment tax if the operation constitutes a trade or business "carried on by such individual."[130] Similarly, an individual rendering services is subject to self-employment tax if the activity rises to the level of a trade or business.[131] In general, continuity and regularity of activity are necessary before a venture can be considered a trade or business.[132]

1. *Conservation Reserve Program ("CRP") Payments*

a. *Historic Position of the IRS.*

A significant question is whether CRP payments are subject to self-employment tax in the hands of the recipient. In a 1988 letter ruling, the IRS indicated that, for a retired taxpayer who is not materially participating, payments received under the federal Conservation Reserve Program would not be considered net income from self-employment.[133] For active farmers, payments are considered as earned income.[134] The Associate Chief Counsel, Technical, of the IRS has stated that where the farm operator or owner is materially participating in the farm operation, CRP payments constitute receipts from farm operations includable in net earnings from self-employment.[135] The Commissioner of Social Security agrees. Thus, the IRS and the Social Security Administration initially seemed to be taking the position that *someone* must be materially participating.

129. I.R.C. § 1402(a)(1) (2004). *See, e.g.*, Mizell v. Comm'r, 70 T.C.M. (CCH) 1469 (1995).

130. Rudman v. Comm'r, 118 T.C. 354, 357 (2002) (holding that income from commodities futures trades is self-employment income because trades made within scope of taxpayer's business as commodities trader even though trades made through broker).

131. *See* I.R.C. §§ 1402(c), 162(a) (2004).

132. *See* Comm'r v. Groetzinger, 480 U.S. 23, 35 (1987).

133. Priv. Ltr. Rul. 88-22-064 (June 3, 1988) (noting no tenant involved; therefore, landowner's activities under CRP did not constitute material participation).

134. *See id.*

135. Letter from Peter K. Scott, Associate Chief Counsel, Technical, March 10, 1987. (copy on file with authors).

A 1996 Tax Court case[136] and an IRS Technical Advice Memorandum support this position.[137]

The Tax Court in 1998 held that CRP payments are rental payments and are not subject to self-employment tax.[138] The Tax Court said the primary purpose of the CRP contract was to achieve specified environmental benefits by converting highly erodible cropland to soil conserving use.[139] Thus, the contract payments represented compensation from the use restrictions on the land rather than remuneration for the taxpayer's labor.[140] Earlier, the Tax Court had held that, for taxpayers who materially participate in the operation, CRP payments are to be reported as self-employment income.[141] The *Wuebker* court disapproved the *Ray* rationale,[142] but on appeal the Sixth Circuit Court of Appeals embraced the *Ray* analysis,[143] reversing the Tax Court's opinion. [144]

b. *IRS Change of Position*

The IRS, in a Chief Counsel's Advice ("CCA") Letter Ruling dated May 29, 2003, took the position, directly contrary to Private Letter Rule 88-22-064,[145] that a landowner's activities under a CRP contract amount to material participation and the payments should be reported on Schedule F, not Schedule E or Form 4835.[146] That is the Chief Counsel's position for retired landowners as well as those conducting a farming business and those who are not conducting a farming

136. Ray v. Comm'r, 72 T.C.M. (CCH) 780 (1996) (holding CRP rents paid to farms conducting active farming operation subject to self-employment tax).

137. Tech. Adv. Mem. 96-37-004 (Sept. 13, 1996).

138. Wuebker v. Comm'r, 110 U.S.T.C. 431, 432 (1998).

139. *Id.* at 437.

140. *Id.* at 438.

141. *Ray*, 72 T.C.M. (CCH) 780 (holding CRP payments of materially participating landowner subject to self-employment tax and CRP land had a "direct nexus" with business of farming); Tech. Adv. Mem. 96-37-004, (Sept. 13, 1996) (holding that husband and wife as directors and officers of family ranch corporation materially participating in overall operation).

142. *Wuebker*, 110 U.S.T.C. at 439.

143. Comm'r v. Wuebker, 205 F.3d 897 (6th Cir. 2000). Legislation has been introduced to treat CRP payments as rent for self-employment tax purposes. *See* S. 2422, S. 2344, H.R. 4212, 106th Cong., 2d Sess. (2000); S. 315, 107th Cong. (2001); S. 665, S. 1316, 108th Cong. (2003); H.R. 5169, 108th Cong. (2004).

144. *Wuebker*, 205 F.3d at 905.

145. Priv. Ltr. Rul. 88-22-064 (June 3, 1988).

146. Chief Couns. Advice Ltr. Rul. 2003-25-002 (May 29, 2003).

business.[147] The ruling is expected to place even more pressure on the Congress to enact legislation to address the issue.[148]

The 2003 CCA letter ruling states, as to issues and conclusions, the following:

> 1. Whether annual "rental" payments received by Taxpayer A, who is an individual, for land enrolled in the CRP constitute self-employment income to Taxpayer A that is subject to SECA tax where Taxpayer A was engaged in the trade or business of farming prior to enrolling the land in the CRP and Taxpayer A personally fulfilled the CRP contractual obligations.
>
> 2. Whether annual "rental" payments received by Taxpayer B, who is an individual, for newly acquired land, that had been enrolled in the CRP by the land's previous owner and the enrollment is continued by the Taxpayer B, constitute self-employment income to Taxpayer B subject to SECA tax where Taxpayer B was not engaged in the trade or business of farming prior to acquiring the land but Taxpayer B personally fulfilled the CRP contractual obligations.
>
> 3. Whether the annual "rental" payments respectively received by Taxpayer A and Taxpayer B under the CRP should be reported (i) on Schedule F (Form 1040), Profit or Loss from Farming, as farming income from a trade or business, (ii) on a Schedule E (Form 1040), Supplemental Income and Loss, as rental income from real estate, or (iii) on a Form 4835, Farm Rental Income and Expenses, as rental income from crop or livestock production.
>
> CONCLUSIONS
>
> 1. The annual "rental" payments received by Taxpayer A for land enrolled in the CRP constitute self-employment income to Taxpayer A that is subject to Self-Employment Contributions Act ("SECA") tax where Taxpayer A was engaged in the trade or business of farming prior to enrolling the land in the CRP and Taxpayer A personally fulfilled the CRP contractual obligations.
>
> 2. The annual "rental" payments received by Taxpayer B for newly acquired land, that had been enrolled in the CRP by the land's previous owner and the enrollment is continued by Taxpayer B, constitute self-employment income to Taxpayer B subject to SECA tax where Taxpayer B was not engaged in the trade or business of farming prior to acquiring the land but Taxpayer B personally fulfilled the CRP contractual obligations.
>
> 3. The annual "rental" payments respectively received by Taxpayer A and Taxpayer B under the CRP constitute self-employment income to the recipient taxpayer that is subject to SECA tax and is not rental income that is excludable

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147. *Id.*

148. *See* I.R.C. § 469(h)(1) (2004).

> under the rentals-for-real-estate exclusion. The respective payments received by each recipient taxpayer must be reported on a Schedule F and Schedule SE (Form 1040), Self-Employment Tax, filed by that taxpayer with that taxpayer's Form 1040, U.S. Individual Income Tax Return. The use of Schedule E or Form 4835 is not allowed.[149]

The 2003 ruling went on to state, "[f]urthermore, participation in a USDA land diversion program and in the devotion of such land to conservation purposes under such programs will be treated as material participation in the operation of a farm with respect to the diverted acres."[150]

c. *What Involvement is Required under a CRP Contract?*

For income to be subject to self-employment tax, the income must be derived from the taxpayer's conduct of a trade or business.[151] That raises a significant question as to the correctness of the 2003 ruling.[152] While the conclusion of the 2003 CCA letter ruling is not surprising as to the first issue raised (indeed, the conclusion merely restates the historic IRS position), the conclusion as to the second issue is contrary to previous IRS rulings and court opinions.[153] As stated above,[154] the IRS and Commissioner of Social Security require that for CRP rent to be subject to self-employment tax, someone must be materially participating in the farming operation. Is the act of merely signing a CRP contract or acquiring land subject to an existing CRP contract sufficient to constitute the conduct of a trade or business as required by the statute?

As to the extent of involvement under a CRP contract, the owner or operator must agree to:

> 1. implement a plan approved by the local conservation district to convert highly erodible crop land to less intensive use, including pasture, grass, legumes, forbs, shrubs or trees;
>
> 2. place the highly erodible land specified in the contract in reserve so as not to be used for agricultural purposes except as permitted by the Secretary of Agriculture;
>
> 3. establish vegetative cover on the land;

149. Chief Couns. Advice Ltr. Rul. 2003-25-002 (May 29, 2003).
150. *Id.*
151. *See* I.R.C. §1402(a) (2004).
152. Chief Couns. Advice Ltr. Rul. 2003-25-002 (May 29, 2003).
153. *Id.*
154. *Id.*

4. forfeit all rights to rental and cost sharing payments and refund any rental and cost sharing payments received under the contract, with interest, upon termination of the contract resulting from a violation of the terms of the contract;

5. refund to the Secretary of Agriculture or accept adjustments to the rental and cost sharing payments provided to the owner for violation of the terms of the contract which does not cause termination of the contract;

6. forfeit all rights to rental and cost sharing payments under the contract upon transfer of the land, unless the transferee of the land agrees to assume all obligations of the contract;

7. refund rental and cost sharing payments or accept adjustments in the rental and cost sharing payments, unless the transferee of the land agrees to assume all obligations of the contract;

8. not make any commercial use, such as harvesting or grazing, of the forage on the contract land, unless permitted by the Secretary of Agriculture in case of drought or other emergency;

9. not plant trees on the contract land unless permitted by the contract, except that customary forestry practices may be allowed on land converted to forestry use;

10. not adopt any practice specified in the contract which may defeat the purposes of the program; and

11. comply with any additional contract provisions.[155]

The significant question, after CCA Ltr. Rul. 2003-25-002[156] is whether the above enumerated items constitute material participation in a farming operation. It would appear that precisely the opposite results.

d. *Recent Developments*

On March 26, 2004, a conference was organized by Rep. Earl Pomeroy (D. ND) and was held in Bismarck, North Dakota, on the issue with state and regional IRS representatives present. Professor Neil E. Harl participated by teleconference. The outcome was inconclusive with IRS representatives reluctant to commit to harmonization of the conflicting IRS authorities (Ltr. Rul. 88-22-064, March 7, 1988 and CCA Ltr. Rul. 2003-25-002, May 29, 2003). Rep. Pomeroy, on June 8, 2004, arranged a one-hour meeting in Washington, DC involving five

155. 16 U.S.C. § 3832(a) (2003).
156. *See* CCA Ltr. Rul. 2003-25-002 (May 29, 2003).

senior IRS administrators (one of whom was Mark Everson, Commissioner of Internal Revenue), Rep. Pomeroy and his staff and Prof. Harl. Prof. Harl's recommendations were the following.

1. A withdrawal of CCA Ltr. Rul. 2003-25-002, May 29, 2003, or reissuance with a narrowing of the ruling to harmonize with Ltr. Rul. 88-22-064, March 7, 1988, would remove much of the current confusion.
2. The CCA letter ruling seems to apply to all federal conservation programs also. It would be helpful to know whether that was intended.
3. Guidance on the matter of SE tax liability for those who retire during the term of the CRP contract would be helpful.

The Commissioner asked for additional background material and agreed that the Service would attempt to harmonize the IRS authorities.

2. *Value-Added Distributions*

A 1998 Tax Court decision, issued as a small case opinion, indicated that a retired farmer is not subject to self-employment tax on payments from a value-added cooperative.[157] The cooperative was considered to be corporate entity, not a partnership.[158] The interest in the value-added cooperative required delivery of corn, but the taxpayer no longer produced corn so the taxpayer was allowed to fulfill the obligation to deliver corn by paying a small fee and drawing from a pool maintained for members whose production fell below their commitment to deliver.[159] The Chief Counsel later conceded the issue.[160] However, in 2002, the Tax Court held that retired farm taxpayers had to report value-added payments

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157. Robert J. Hansen, T.C. Summ. Op. 1998-91. (copy on file with authors).

158. *Id.*

159. *Id.*

160. I.R.S. Chief Couns. Notice N(36)000-3 (April 21, 1999), *available at* http://www.unclefed.com/ForTaxProfs/irs-ccdm/1999/farmcoop.pdf (stating that document assumes that Form 4835 does not reveal that taxpayer actively participated in farming operation that could indicate a nexus with grain production which may support a conclusion that a farmer in a trade or business of grain processing).

involving the delivery of corn as self-employment income.[161] The Tax Court followed its holding in *Bot*[162] and in two other cases in 2005.[163]

A related issue involves the timing of the reporting of value-added distributions. Use of this procedure will be effective for deferral income tax in addition to any self-employment tax that might apply. In a 2004 case, year-end payments received by an agent from a value-added cooperative were deemed to be constructively received by the taxpayer.[164] However, in a 1982 case, the sale of a cotton crop on a deferred basis with payment to an irrevocable escrow account established by a cotton gin with no right by the taxpayers to the funds until the following taxable year succeeded in thwarting a constructive receipt challenge.[165] Use of this procedure will be effective for deferral of income tax in addition to any self-employment tax that might apply.

3. *Update on* Mizell

In *Mizell*, the lease of property to an entity in which the lessee is also a partner has been held to result in treatment of the lease payments as self-employment income.[166] The statute at issue in *Mizell* (and the subsequent cases), I.R.C. § 1402(a)(1), provides as follows:

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

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161. Bot v. Comm'r, 118 T.C. 138, 153 (2002), *aff'd*, 353 F.3d 595 (8th Cir. 2003) (holding that taxpayer engaged in trade or business of acquisition and sale of corn to cooperative; direct nexus to trade or business of farming).

162. *Id.*

163. Fultz v. Comm'r, T.C.M. (RIA) 2005-46 (2005) (The cooperative was the taxpayer's agent for marketing and selling corn pursuant to a uniform marketing agreement. The Court rejected the argument that all rights had been assigned to the corporation, so the payment was rent.).

164. Scherbart v. Comm'r, 87 T.C.M. (CCH) 1418 (2004).

165. Busby v. United States, 679 F.2d 48, 50 (5th Cir. 1982).

166. Mizell v. Comm'r, 70 T.C.M. (CCH) 1469 (1995) (discussing crop share lease of land to family farm partnership where court focused on "arrangement" which encompassed taxpayer's involvement as a partner as well as involvement under lease). *See also* Rev. Rul. 60-170, 1960-1 C.B. 357 (holding payments received by farmers under "lease" agreement with steel company as result of damages because of fumes and gases not considered income from self employment even though farmer had right to continue full use of land).

> is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss:
>
> (1) There shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer; except that the preceding provisions of this paragraph shall not apply to any income derived by the owner or tenant of land if (1) such income is *derived under an arrangement*, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and (2) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity . . . .[167]

By its terms, the exception to the rental real estate exclusion applies only to agricultural taxpayers.[168] IRS succeeded in *Mizell* in arguing that the income "derived under an arrangement" language in the statute allowed them to examine the taxpayer's involvement in the farming operation as a whole (rather than simply examining the taxpayer's involvement under the lease) to determine if taxpayer's involvement had risen to the level of a trade or business.[169]

After their win in *Mizell*, IRS applied the same analysis to rental of land and personal property to a corporation.[170] However, the cases of *McNamara*,

167. I.R.C. § 1402(a)(1) (2004). (emphasis added).

168. *Id.* For those not producing agricultural or horticultural commodities, self-employment tax may be imposed when the work is performed by agents. *See, e.g.*, Klusken v. Comm'r, 78 T.C.M. (CCH) 939 (1999).

169. *See Klusken*, 78 T.C.M. (CCH) 939 (stating that for those not producing agricultural or horticultural commodities, self-employment tax may be imposed when the work is performed by agents).

170. *Mizell*, 70 T.C.M. (CCH) 1469. *See, e.g.*, Tech. Adv. Mem. 96-37-004 (Sept. 13, 1996) (holding that husband and wife as officers and directors of corporation had self-employment income from land cash rented to corporation). *See* Bot v. Comm'r, 118 T.C. 138, 153 (2002), aff'd, 353 F.3d 595 (8th Cir. 2003) (holding that wife who rented land to husband's sole proprietorship was materially participating in operation); Hennen v. Comm'r, 78 T.C.M. (CCH) 445 (1999) (finding same outcome as *Bot*); McNamara v. Comm'r, 78 T.C.M. (CCH) 530 (1999) (holding that husband and wife, joint tenants, who cash rented land to husband's corporation had self-employment tax on rents); I.R.S. Field Serv. Advisory, 1999-17-005 (Apr. 30, 1999) (finding that

Hennen, and *Bot*, were consolidated and reversed on December 29, 2000, by the U.S. Circuit Court of Appeals for the Eighth Circuit.[171] The Eighth Circuit focused on the "nexus" between the lease and the farming operation and stated that "the mere existence of an arrangement requiring and resulting in material participation in agricultural production does not automatically transform rents received" into self-employment income.[172] The Court pointed out that rents consistent with market rates "very strongly suggest" that the rental arrangement should stand on its own as an independent transaction without self-employment tax being due.[173] On remand, the Tax Court agreed that the rents in the three 1999 Tax Court cases were fair market rentals.[174] On October 20, 2003, IRS entered a non-acquiescence to the Eighth Circuit's opinion as well as the *Hennen* and *Bot* cases.[175]

On March 9, 2004, the Tax Court filed two decisions, both appealable to the Eighth Circuit Court of Appeals. In one decision, the Tax Court found that the rental paid on a hog barn (calculated at twenty-one dollars per hog per rotation) was above a fair market rental and subject to self-employment tax.[176] The Tax Court found there was a nexus between the hog barn and the taxpayer's material participation in the operation.[177] In the other decision, the Tax Court found that the land rentals were fair market rentals, there was a direct nexus between the rent paid and the material participation by the taxpayers and no self-

husband rented farmland from wife who was involved in farming operation and imposing self-employment tax); I.R.S. Field. Serv. Advisory 1999-17-008 (Apr. 30, 1999) (finding husband and wife rented land to corporation owned by husband where both were involved in operation and holding that self-employment tax imposed).

171. McNamara v. Comm'r, 236 F.3d 410 (8th Cir. 2000).

172. *Id.* at 413.

173. *Id.*

174. GARY HOFF, UNIV. OF ILL., ALTB 04-07 SELF EMPLOYMENT TAX ON RENTED FARMLAND (2004), *available at* http://www.farmdoc.uiuc.edu/legal/taxation/articles/ALTB_04-07/ALTB_04-07.html. The IRS declined the opportunity for a Tax Court hearing. Another case was docketed in the Tax Court which would have been appealable to the Eighth Circuit Court of Appeals, but that case has been dismissed. *See* Wayne Milton, T.C. Docket No. 13594-01. A case appealable to the Second Circuit Court of Appeals was also docketed in the Tax Court. Fowler v. Comm'r, T.C. Docket No. 013920-01 (Dec. 14, 2001) (copies on file with authors). That case was dismissed in September of 2003 in a settlement with IRS.

175. *McNamara*, 236 F.3d 410 (8th Cir. 2000), *action on dec.*, 2003-42 I.R.B. 839 (Oct. 20, 2003); Bot v. Comm'r, 118 T.C. 138 (2002), *action on dec.*, 2003-42 I.R.B. 839 (Oct. 20, 2003); Hennen v. Comm'r, 78 T.C.M. (CCH) 445, *action on dec.*, 2003-42 I.R.B. 839 (Oct. 20, 2003).

176. Solvie v. Comm'r, 87 T.C.M. (CCH) 1049 (2004).

177. *Id.*

employment tax was due.[178] Legislation has been introduced on several occasions (but has not passed) to change "an arrangement" to a "lease agreement" in I.R.C. § 1402(a)(1).[179]

B. *Taxation of Gains from Commodity Certificates*

With government farm payments composing almost half of net farm income in some years, the focus on how the subsidies are to be reported has taken on added importance. The problem is complicated by three features: (1) farmers can elect to have Commodity Credit Corporation ("CCC") loans treated as loans or as income;[180] (2) the subsidies are delivered to eligible participants in three distinctly different systems of payments; and (3) dollar limitations on payments have been imposed by the Congress,[181] although in recent years Congress has provided a way to avoid the payment limitations[182] through the use of a statute-based procedure involving commodity certificates.[183]

1. *Options for Receiving Subsidies*

As noted above, federal farm subsidies involving the production of "program commodities" (those in which a payment is provided) are made available to producers under three mutually exclusive options. One of the most widely used is called a "loan deficiency payment" ("LDP").[184]

> **Example:** Assume the corn loan rate (which is set by Congress) is $1.90 per bushel. A Commodity Credit Corporation loan (CCC is a federally chartered corporation formed essentially as fiscal agent of the USDA) could be obtained for $1.90 per bushel of eligible corn. With an LDP, however, a CCC loan is not obtained. Rather, a payment is made to the eligible participant (farm tenant, owner-operator, or share-rent landowner) based upon the amount by which the loan rate exceeds the

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178. *See* Johnson v. Comm'r, 87 T.C.M. (CCH) 1057 (2004).

179. *See* S. 569, 106th Cong. (1999); H.R. 1044, 106th Cong. (1999); S. 1861, 106th Cong. (1999); S. 2422, 106th Cong. (2000); S. 312, 107th Cong. (2001); S. 665, 108th Cong. (2003); H.R. 5169, 108th Cong. (2004).

180. I.R.C. § 77(a) (2004). *See also* Rev. Proc. 2002-9, 2002-3 I.R.B. 1.01(2) (The CCC is the vehicle for two of the three ways program benefits are delivered to farmers and landowners.).

181. *See* Farm Security and Rural Investment Act of 2002, 7 U.S.C. § 1308-3a (2002).

182. *See* Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriation Act of 2000, 7 U.S.C. § 1421 (1999).

183. *See* Farm Security and Rural Investment Act of 2002, § 1608 (amending 7 U.S.C. § 7286 (2000)).

184. *Id.* at § 7935.

Posted County Price ("PCP"). Assuming the PCP is $1.60 per bushel, the eligible participant would receive a payment of thirty cents per bushel. The eligible participant would be ineligible for either of the other two options.

The thirty cents-per-bushel payment would be reported to the IRS and to the taxpayer on a Form CCC 1099G, Information Return and by the taxpayer on Schedule F, and would be subject to the payment limitation for combined marketing loan gains and LDPs. That limit is $75,000.[185]

The second option, for eligible participants, is to use a "marketing loan" which may produce a "marketing loan gain."

Example: Once again, assume a corn loan rate of $1.90 per bushel and a PCP of $1.60 per bushel. The eligible participant would take out the loan at $1.90 per bushel and could repay the loan at $1.60 per bushel. That would produce a marketing loan gain of thirty cents per bushel of corn.[186]

Again, the thirty cents-per-bushel payment would be reported to IRS and to the taxpayer on a Form CCC 1099G, Information Return and by the taxpayer on Schedule F, and would be subject to the payment limitation for marketing loan gains and LDPs.[187]

185. *See id.* at § 1308.

186. *See* 7 U.S.C. § 7231 (2004). Marketing loans can be repaid at the lesser of principal plus interest or the posted county price (or adjusted world price, for cotton). 7 U.S.C. § 7234 (2004). If the PCP is below the loan rate, it produces a marketing loan gain. In general, that gain must be reported in the year the loan is repaid. There is some support for the argument that taxability of the marketing loan gain can be deferred until the year the commodity is sold for those who have elected to treat CCC loans as income (which gives the commodity a basis as the amount of the commodity equal to the loan amount is reported into income). *See* I.R.C. § 1016(a)(8) (2004) (noting adjustment in basis is to be made "in the case of property pledged to the Commodity Credit Corporation, to the extent of the amount received as a loan from the Commodity Credit Corporation and treated by the taxpayer as income for the year in which received pursuant to section 77, *and to the extent of any deficiency on such loan with respect to which the taxpayer has been relieved from liability.*") (emphasis added). *See also* INTERNAL REVENUE SERV., 225: FARMERS TAX GUIDE 12 (2004) *available at* http://www.irs.gov/publications/p225/ch12.html; INTERNAL REVENUE SERV., MARKET SEGMENT SPECIALIZATION PROGRAM: GRAIN FARMERS, 7-17 (1995) *at* http://www.irs.gov/businesses/page/0,,id%3D7039,00.html (last visited May 12, 2005). *Cf.* Rev. Rul. 87-103, 1987-2 C.B. 41. This was issued to address income tax treatment with use of commodity certificates to redeem commodities under CCC loan. Deferral is accomplished by reducing the income tax basis for the commodity.

187. *See* Farm Security and Rural Investment Act of 2002, 7 U.S.C. §1308-3a (2002).

Thus, marketing loans are basically CCC loans and are subject to the usual rules governing such loans, including treatment of such loans as loans or the election to report the loan amount as income.[188]

Example for corn: Corn is placed under CCC loan ($500) in 2004. In 2005, the commodity is redeemed when the county posted price is $420. The commodity is sold later in 2005 for $600.

With I.R.C. § 77(a) election —

Gain in 2004	$500
Gain in 2005	180

Without I.R.C. § 77(a) election —

Gain in 2004	-0-
Gain in 2005	680[189]

The third option is to use a special procedure, the details of which were developed by the USDA several years ago, by using "commodity certificates" (which are available for wheat, cotton, rice, feed grains, and oil seeds).[190] With that procedure, the eligible participant takes out a CCC loan for the commodity loan rate and, in essentially the same transaction, purchases a commodity certificate of a size needed to repay the loan at the PCP.[191]

Example: Again, assume a corn loan rate of $1.90 per bushel and a PCP of $1.60 per bushel. Repayment of the CCC loan at $1.60 per bushel produces a loan gain of thirty cents per bushel of corn.[192]

The thirty cents per bushel gain, however, is *not* reported to the IRS under current practice of the government agency involved (Farm Service Agency) and does *not* count against the payment limitation.[193] Indeed, this third option,

188. *See* I.R.C. § 77(a) (2004).
189. Rev. Rul. 87-103, 1987-2 C.B. 41.
190. GEOFFREY S. BECKER, CONG. RESEARCH SERV., FARM COMMODITY PROGRAMS: A SHORT PRIMER 3 (2002), *available at* http://www.ncseonline.org/NLE/CRSreports/RS20848.pdf.
191. FARM SERV. AGENCY, USDA, FACT SHEET: COMMODITY CERTIFICATES (2000), *available at* http://www.fsa.usda.gov/pas/publications/ facts/html/commcert00.htm.
192. *See id.*
193. News Release, Internal Revenue Service, IRS Reminds Farmers How to Report Market Gain When Using Commodity Credit Corporation (CCC) Certificates to Facilitate Repay-

involving commodity certificates, is generally used when the eligible participant expects to encounter the payment limitation.[194]

The fourth option is to forfeit the commodity under loan to the CCC in satisfaction of the loan. Under this option, the gain involved is reported to IRS and the taxpayer on Form 1099A (for abandonments). The process is handled by county offices. Like the commodity certificate approach, the gain involved does not count toward the $75,000 payment limitation.[195]

In all four instances, if the eligible individual actually sells the corn for $1.80 per bushel, the eligible participant would have received a thirty cent per bushel subsidy and would have realized (and recognized) $1.80 per bushel on the actual sale of the commodity for a total of $2.10 per bushel of corn. The economic benefit under the four options is comparable (other than for the relief from the payment limitations) if the taxpayer in the third option reports properly the thirty cent per bushel of gain on the exchange. If the taxpayer does not report the gain under the third option, the benefit of that option is proportionately greater by the amount of the income tax benefit from not reporting the gain.[196]

The key issues involve why the USDA does not report the gains under the third option to the IRS via an information return as is done with the other options, and what are the behavioral consequences of having an option where payments are not tracked with an information return (not to mention that the amounts also do not count against the payment limitation).[197]

2. *IRS Response*

While IRS acknowledges that all four options produce taxable gain, they remain steadfast in their unwillingness to order Form 1099 reporting for gains from paying off CCC loans with commodity certificates.[198]

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ment of CCC Loans, IR-2004-38 (Mar. 18, 2004), *at* http://www.irs.gov/newsroom/article/0,,id=121355,00.html (last visited May 12, 2005).

194. GEOFFREY S. BECKER, *supra* note 190 at 5.

195. News Release, Internal Revenue Service, *supra* note 193.

196. *See* Neil E. Harl and Roger A. McEowen, *Inconsistency in Handling Farm Income?* 99 TAX NOTES 923, 924 (2003).

197. *Id.* The importance of the matter is underscored by the fact that nearly $2 billion in commodity certificate gains was triggered in 2001.

198. News Release, Internal Revenue Service, *supra* note 193. *See also* Neil E. Harl & Roger A. McEowen, *supra* note 196 at 476.

C. *Gains and Losses from Commodity Trades – The Line Between Hedging and Speculation*

1. *The Insurance Test*

Courts emphasize two tests in evaluating commodity futures transactions as hedges or as speculative ventures, the insurance test, and the direct relation test.[199] Under the insurance test, if the taxpayer uses futures trading to offset price changes in actual commodities (the "actuals"), the futures transactions are hedges.[200] Even if the taxpayer was not using futures trading to offset price movements in actuals, the U.S. Supreme Court has held that futures trading was hedging and not speculation if the commodity transactions were an integral part of the taxpayer's business as where futures trading was used as price insurance against subsequent price increases with respect to needed raw materials.[201]

In *Corn Products Refining Co.*, the taxpayer purchased corn futures during harvest when prices were lower as a "pre-hedge" effort to guard against price increases.[202] The court held that the transactions were not speculative dealings but were an integral part of its business and were designed to assure a ready supply of corn for manufacturing purposes while protecting itself against price increases.[203] The court denied long-term capital gain treatment for profits from futures transactions (which is the proper treatment for speculative gains) and held that the gains were ordinary income.[204]

The courts have been asked to apply *Corn Products Refining Co.* to post-harvest sales of crops and purchases of like amounts of commodities in the futures market under the theory that the post-harvest position in the futures market

199. *See, e.g.*, Stewart Silk Corp. v. Comm'r, 9 T.C. 174 (1947) (applying the insurance test); Comm'r v. Banfield, 122 F.2d 1017 (9th Cir. 1941) (applying the direct relation test).

200. *See, e.g.*, *Stewart Silk Corp.*, 9 T.C. at 178.

201. Corn Prods. Refining Co. v. Comm'r, 350 U.S. 46 (1955); Crisp v. Comm'r, 58 T.C.M. (PH) 668 (1989) (holding futures transactions required as part of loan agreement were integral part of cattle raising business and gains were ordinary income). *See also* Myers v. Comm'r, 55 T.C.M. (PH) 518 (1986) (holding that losses from sales of commodity futures contracts were capital losses where taxpayers failed to demonstrate that purchase of contracts was intended as hedge as to commodities produced by taxpayers).

202. *See Corn Prods. Refining Co.*, 350 U.S. at 46.

203. *Id.* at 50.

204. *See id.* at 52-54.

was an integral part of the farming operation.[205] If the futures transaction is entered into after the actual commodity has been disposed of, there is no remaining risk of price change in the actual commodities, the insurance test is not met and gains and losses are capital gains and losses.

The U.S. Supreme Court, in *Arkansas Best Corp.*,[206] limited *Corn Products Refining Co.* to its facts in allowing ordinary income from sales of commodity futures by stating, "*Corn Products* is properly interpreted as standing for the narrow proposition that hedging transactions that are an integral part of a business' inventory-purchase system fall within the inventory exclusion of § 1221."[207]

After 1988, IRS took the position that futures market transactions involving the purchase of short hedges were not hedges and were to be treated as capital assets.[208] However, the Tax Court has held that hedging of debentures and mortgages with short sales of U.S. Treasury securities produced ordinary gains and losses.[209] The court agreed with the taxpayer that it was not necessary to offset the entire risk for the transaction to be a hedge. The court noted that for a hedging position to produce ordinary gain and loss treatment, the transaction must be integrally related to the purchasing and holding of the assets hedged. The IRS later abandoned its position in regulations initially issued in late 1993

205. Patterson v. Comm'r, 41 T.C.M. (CCH) 807 (1981) (discussing a farmer who sold soybeans at harvest because of inadequate storage and bought soybean futures where transactions were held to be speculative, not hedges, on grounds that the taxpayer was not protecting against risk of loss as to actual commodities and rejecting argument that the *Corn Products Refining Co.* doctrine should apply). Hedging Transactions, 59 Fed. Reg. 36361-36362 (July 18, 1994) (to be codified at 26 C.F.R. pts. 1 and 602) (stating the IRS's position on hedging). *See also* Comm'r v. Farmers & Ginners Cotton Oil Co., 120 F.2d 772 (5th Cir. 1941); Trenton Cotton Oil Co. v. Comm'r, 147 F.2d 33 (6th Cir. 1945).

206. Arkansas Best Corp. v. Comm'r, 485 U.S. 212 (1988).

207. *Id.* at 222. *See also* Gerald A. Heggestad, 91 T.C. 778 (1988) (holding that sale of Treasury bill futures contracts produced capital loss where contracts purchased by partner in brokerage firm as means of producing income to cover losses of partner's clients; contracts were investments even though business reason also involved); The Circle K Corp. v. United States, 23 Cl. Ct. 161 (1991), *modified*, 23 Cl. Ct. 665 (1991), *vacated*, 91-2 U.S.T.C. ¶ 50,382 (Cl. Ct. 1991) (finding that ordinary loss treatment for loss on stock of company acquired to assure source of supply for retail operations and the purchase was characterized as integral part of company's inventory purchase system and so excluded from definition of capital asset).

208. *See* Letter, Stuart L. Brown, Associate Chief Counsel, Domestic, Internal Revenue Service, to Henry Bahn, USDA, Jan. 27, 1993. (copy on file with author).

209. Fed. Nat'l Mortgage Ass'n v. Comm'r, 100 T.C. 541, 569 (1993).

and made final in 1994.[210] Under the regulations, to receive ordinary loss treatment, taxpayers must identify hedges when entered into along with the item or items hedged.[211] The regulations also require that hedging transactions entered into on or after January 1, 1994, must be identified as such before the close of the day on which the taxpayer enters into the hedge.[212] The hedged items or aggregate risk must be identified within thirty-five days after entering into the hedging transactions.[213] The identification must be made and retained on the taxpayer's books and records and must specify the hedging transaction and what is being hedged.[214]

If a transaction is a hedge, the transaction must be accounted for using a method of accounting permissible under Treas. Reg. § 1.446-4 even though the taxpayer fails to identify the transaction.[215] In the event a taxpayer uses a method of accounting that is not permissible, the Commissioner's consent must be obtained before changing to a permissible method.[216]

A taxpayer may hedge any part or all of its risk for any part of the period during which it has risk.[217] The frequent entering into and termination of hedging positions are not relevant to whether transactions are hedges.[218] Non-inventory supplies may be hedged if only a negligible amount is sold.[219] For a hedging program undertaken to reduce the overall risk of the taxpayer's operation, the taxpayer generally does not have to demonstrate that each hedge entered into pursu-

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210. Treas. Reg. § 1.1221-2 (2002); Treas. Reg. § 1.446-4 (as amended in 2002). *See* Tech. Adv. Mem. 94-17-004 (Apr. 29, 1994) (finding Eurodollar futures contracts used to reduce interest rate risk were hedges and produced ordinary gains and losses).

211. Treas. Reg. § 1.1221-2(f)(1)-(2).

212. Treas. Reg. § 1.1221-2(f)(1); Proposed Treas. Reg. 1.125b(e)-1 (2004).

213. *See* Proposed Treas. Reg. §§ 1.221-2 (e)(2)(ii), 1.1221-2 (f)(1), 1.1256(e)-1.

214. For hedges entered into before January 1, 1994, that remained in existence on March 31, 1994, the identification had to be made before the close of business on March 31, 1994. *See* Treas. Reg. § 1.1221-2(g)(1). There are consequences of failing to identify transactions properly. If a taxpayer identifies a transaction as a hedging transaction and it is not a hedge, gains are ordinary but losses may be capital. *See* Proposed Treas. Reg. § 1.1221-2(f)(1) (2004). If a transaction satisfies the definition of a hedge but it is not identified as a hedge, gains are ordinary and losses are capital. *See id.* at § 1.1221-2(f)(2)(iii). Exceptions are provided for inadvertence. Thus, the regulations have been made the exclusive way to receive treatment as a hedge. That result has been criticized. *See* Paul M. Schmidt, *The Hedging Rules: Clarity or Confusion?*, 72 TAX NOTES 1169, 1169 (1996).

215. Rev. Rul. 2003-127, 2003-52 I.R.B. 1246.

216. *Id.*

217. Treas. Reg. § 1.1221-2(d)(7)(i) (2004).

218. *Id.* at § 1.1221-2(d)(7)(ii).

219. *Id.* at § 1.1221-2(f)(3)(ii).

ant to the program reduced overall risk.[220] A taxpayer who attempts to hedge cannot attribute an entity's business to an individual taxpayer, or vice versa, for purposes of satisfying the definition of a hedging transaction under Treas. Reg. § 1.1221-2(b).[221]

In the preamble to the final regulations issued in 1994, IRS seemed to sanction the hedging of deficiency payments stating:

> The IRS and Treasury understand that there are situations in which a taxpayer engages in a store-on-the-board transaction as a hedge of an expected payment under an agricultural price support program. In this situation, a long futures or forward contract may qualify as a hedging transaction with respect to the expected payment.[222]

Interest rate swaps by banks following the purchase of fixed rate, tax-exempt bonds has qualified as a hedge even though the swaps reduced the risk with respect to assets that gave risk to tax-exempt income.[223] In a 1993 case, a commodity trader's losses resulting from cancellation of forward contracts and replacement with new contracts having different delivery dates were ordinary losses.[224]

2. *The "Direct Relation" Test*

Under the "direct relation" test, there must be a direct relation between the taxpayer's business and the commodity market transaction if the transaction is to be considered a hedge.[225] For the direct relation test to be met, the amount of

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220. *Id.* at § 1.1221-2(c)(4)(ii).

221. Priv. Ltr. Rul. 97-20-003, (May 16, 1997) (discussing dairy farm carried on by S corporation; taxpayer attempting to hedge feed ingredients). *See* Pine Creek Farms, Ltd. v. Comm'r, T.C.M. (RIA) 2001-176 (2001); (finding a C corporation, which was engaged in production of corn, soybeans, cattle and hogs, spun off hog operation into two new C corporations where hedging losses incurred by those corporations on hogs were speculative); Welter v. Comm'r, 86 T.C.M. (CCH) 495 (2003) (finding shareholder of family farm corporation engaged in commodity trades in own name after incorporation and result was capital gains and capital losses).

222. Hedging Transactions, 59 Fed. Reg. 36,362 (July 18, 1994) (to be codified at 26 C.F.R. pts. L and 602).

223. Priv. Ltr. Rul. 98-24-026 (June 12, 1998).

224. *See* Stoller v. Comm'r, 994 F.2d 855 (D.C. Cir. 1993) (entering into futures contract transactions for profits).

225. United States v. Rogers, 286 F.2d 277 (6th Cir. 1961) (holding futures trading did not relate to purchase and sale of livestock). *See* Patton & Richardson, Inc. v. Comm'r, 42 T.C.M. (CCH) 70 (1981) (holding losses by cotton merchant in futures trading were speculative rather than

futures trading in the particular commodity involved and the timing of purchases and sales must be related to the position of the taxpayer in the actuals. Thus, where the amount of futures trading exceeds substantially that needed to provide price protection for actual commodities or the pattern of purchases and sales in futures is not consistent with securing price protection for the actuals, the transactions are likely to be treated as speculative rather than hedges with the result that gains and losses are capital gains and losses.[226]

3. *Accounting for Hedging Transactions*

The method of accounting used by a taxpayer for a hedging transaction must clearly reflect income. To clearly reflect income, the method used must reasonably match the timing of income, deduction, gain or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged. Taking gains and losses into account in the period in which they are realized may clearly reflect income in the case of certain hedging transactions.[227]

For hedges of inventory, gain or loss on the hedge "may be taken into account in the same period that it would be taken into account if the gain or loss were treated as an element of the cost of inventory."[228] "A taxpayer is generally permitted to adopt a method of accounting for a particular type of hedging trans-

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hedging losses); Hendrich v. Comm'r, 40 T.C.M. (CCH) 997 (1980) (holding that pattern of futures trading did not provide price protection for wheat held by taxpayer).

226. *See* Oringderff v. Comm'r, 81-2 U.S.T.C. ¶ 9642 (10th Cir. 1981) (holding that futures transactions on cattle held to be speculative for cattle feeder where many of the transactions were opened and closed the same day even though cattle were on 120 - 150 day feed); Lewis v. Comm'r, 40 T.C.M. (CCH) 1049 (1980) (finding volume of futures trading by cattle feeder was three to five times the cattle on hand); Meade v. Comm'r, 32 T.C.M. (CCH) 200 (1973) (finding pattern of transactions in corn and cattle futures did not provide price protection as to the actuals); Estate of Hazel Laughlin, 30 T.C.M. (CCH) 227 (1971) (finding going "long" on soybeans did not provide price protection for soybeans to be produced). *See also* Oliver v. United States, 83-1 U.S.T.C. ¶ 9356 (E.D. Ark. 1983) (finding farmer engaged in commodity futures trading as speculative transaction and not a hedge); Vickers v. Comm'r, 80 T.C. 394 (1983) (holding that speculative commodity futures transactions for farmer produced losses subject to capital loss limitation); *In re* Blazek, 90-2 U.S.T.C. ¶ 50,528 (Bankr D. Kan. 1990) (finding that taxpayer not precluded from attempting to prove trades were hedges even though majority were speculative).

227. Treas. Reg. § 1.446-4(b) (2004). *See* Priv. Ltr. Rul. 98-32-020 (Aug. 7, 1998) (discussing proposed accounting method for metals merchant satisfied "clear reflection of income" requirement).

228. Treas. Reg. § 1.446-4(e)(3) (2004).

action that clearly reflects the taxpayer's income from that type of transaction."[229] Once a method is adopted, it must be applied consistently.[230] The records must contain a description of the accounting method used.[231] A taxpayer on the cash method of accounting with less than $5 million of gross receipts for all taxable years ending on or after September 30, 1993, is not required to use the above rules.[232] However, such a taxpayer may nonetheless use a method of accounting consistent with these rules.[233]

"If a taxpayer hedges an item and disposes of, or terminates its interest in the item, but does not dispose of or terminate the hedging transaction, the taxpayer must appropriately match the built-in gain or loss on the hedging transaction to the gain or loss on the disposed item."[234] Thus, hedges may be "marked to market" on the date the actuals are disposed.[235] For "recycled" hedges, with a hedge later used

> to serve as a hedge of a different item . . . the taxpayer must match the built-in gain or loss at the time of the recycling to the gain or loss on the original hedged item . . . . [G]ain or loss attributable to the period after the recycling must be matched to the new hedged item.[236]

D. *Repairs v. Capitalization*

In general, expenses are deductible as repairs if the cost involves "incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinary efficient operating condition".[237] Amounts incurred for maintenance and repairs are deductible as ordinary and necessary business expenses.[238] Expenditures that restore a building to its previous condition without adding to the value of the building or prolonging its life are properly deductible.[239] Engine overhaul has been held to be an item

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229. *Id.* § 1.446-4(c).
230. *Id.*
231. *Id.* § 1.446-4(d).
232. *Id.* § 1.446-4(a)(1).
233. *Id.* § 1.446-4(a)(1).
234. *Id.* § 1.446-4(e)(6).
235. *Id.*
236. *Id.* § 1.446-4(e)(7).
237. *Id.* § 1.162-4.
238. Schroeder v. Comm'r, 72 T.C.M. (CCH) 185 (1996).
239. *See* Campbell v. Comm'r, T.C. Summ. Op. 2002-117 (2002) (allowing roof repairs on rented home deductible as repairs).

which can be expensed.[240] Similarly, aircraft engines have been found to be part of a single unit of property under the repair regulations.[241] The IRS has indicated that forthcoming regulations will clarify the handling of repairs as well as expenditures for improving and rehabilitating property.[242]

E. *Like-Kind Exchange Issues*

1. *Six-Digit System*

Depreciable tangible property held for productive use in a trade or business or for investment may be exchanged for property of a like-kind or of like class.[243] However, underlying business assets consisting of intangible personal property are not allowed to be aggregated as a single asset for the purpose of determining whether an exchange of two businesses qualifies as a like-kind exchange.[244] The regulations do not define "depreciable tangible personal property."[245] Moreover, it is not clear to what extent state law governs in the meaning of the term.[246] The term "personal property" is defined for purposes of I.R.C. § 1245 as "(1) [t]angible personal property (as defined in paragraph (c) of § 1.48-1, relating to the definition of 'section 38 property' for purposes of the investment credit), and (2) intangible personal property."[247] The question is whether the term

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240. *See* Ingram Industries, Inc. & Subs. v. Comm'r, 80 T.C.M. (CCH) 532 (2000) (allowing petitioners to deduct cost of their towboat diesel engines that are out of operation for only 10-12 days).

241. *See* FedEx. Corp. v. United States, 121 Fed. Appx. 125 (6th Cir. 2005), *aff'g*, 291 F. Supp. 2d 699, 710 (W.D. Tenn. 2003) (establishing a four part test of (1) whether taxpayer treated component part as part of larger unit of property for any purpose; (2) whether economic useful life of component is co-extensive with that of larger unit; (3) whether larger unit and smaller unit can function independently; and (4) whether component part can and is maintained while affixed to larger unit; aircraft was single unit of property so costs of engine shop visits deductible).

242. I.R.S. Notice 2004-6, 2004-3 I.R.B. 308.

243. Treas. Reg. § 1.1031(a)-2(b)(1). *See* Rev. Proc. 2003-39, 2003-22 I.R.B. 971 (providing guidelines for safe harbor for exchanges of tangible personal property (of 100 or more properties)).

244. Tech. Adv. Mem. 94-48-001 (Dec. 2, 1994) (stating assets underlying replacement property not like-kind to relinquished property and replacement businesses not like-kind to relinquished business).

245. *See* Treas. Reg. § 1.1031(a)-2(b)(1).

246. *See* Tech. Adv. Mem. 2004-24-001 (June 11, 2004) (holding that the railroad track which was laid (real property under state law) was not like-kind to unassembled track which was personal property and real and personal property can never be of like kind).

247. Treas. Reg. § 1.1245-4(b) (1971).

"personal property" as used in I.R.C. § 1031 embraces fully the "other property" branch of I.R.C. § 1245.[248] The term "tangible personal property" as defined for purposes of "section 38 property" has acquired meaning through regulations and cases. The regulations specify that:

> [L]ocal law shall not be controlling for purposes of determining whether property is or is not "tangible" or "personal." Thus, the fact that under local law property is held to be personal property or tangible property shall not be controlling. Conversely, property may be personal property for purposes of the investment credit even though under local law the property is considered to be a fixture and therefore real property.[249]

The investment tax credit regulations have also been applied to situations involving the classification of property for depreciation purposes.[250]

The investment tax credit regulations define "tangible personal property" to mean:

> [A]ny tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures). Thus, buildings, swimming pools, paved parking areas, wharves and docks, bridges, and fences are not tangible personal property. Tangible personal property includes all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which is contained in or attached to a building constitutes tangible personal property for purposes of the credit allowed by section 38. Further, all property which is in the nature of machinery (other than structural components of a building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property.[251]

The term "tangible personal property" has been held to include the following items:

1. air conditioning;[252]

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248. *See* id. § 1.1245-4(c)(1).

249. Treas. Reg. § 1.48-1(c) (2004).

250. *See* Priv. Ltr. Rul. 1999-24-044 (June 18, 1999) (discussing magnetic stripe keycard door locking system for hotels).

251. Treas. Reg. § 1.48-1(c) (2004).

252. Texas Instruments, Inc. v. Comm'r, 63 T.C.M. (CCH) 3070 (1992) (defining tangible personal property to meet temperature and humidity requirements).

2. propane storage tanks;[253]
3. photo labs (but not concrete foundations);[254]
4. bulk tanks and storage tanks used in bulk petroleum distribution and retail operations;[255]
5. fire extinguishers;[256]
6. fixed or floating docks (but not pilings);[257]
7. construction site trailers;[258]
8. billboards, signs, lighting fixtures and detachable poles at retail stations (but not concrete foundations);[259]
9. bank vault doors, record vault doors, night depository facilities and walk-up and drive-up teller's windows (but a drive-up teller's booth is a building).[260]

Property is of a like class to other depreciable tangible personal property if the properties exchanged are within the same general asset class or the same product class.[261] Property cannot be classified within more than one general asset class or more than one product class. Property classified within a general asset class may not be classified within a product class. Depreciable tangible personal property is classified into thirteen general asset classes.[262] The classes are listed in the IRS publication for determining classification for depreciation purposes as asset classes 00.11 through 00.28 and 00.4.[263]

The general asset classes are:

a. office furniture, fixtures and equipment;
b. information systems;
c. data handling equipment;
d. airplanes (other than commercial airliners or freight carriers);

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253. Rev. Rul. 83-146, 1983-2 C.B. 17.
254. Fox Photo, Inc. v. Comm'r, 60 T.C.M. (CCH) 85 (1990).
255. J.C. Siler v. Comm'r, 49 T.C.M. (CCH) 1587 (1985).
256. Rev. Rul. 67-417, 1967-2 C.B. 49.
257. Estate of Morgan v. Comm'r, 52 T.C. 478 (1969).
258. Rev. Rul. 77-8, 1977-1 C.B. 3.
259. Rev. Rul. 80-151, 1980-1 C.B. 7. *See* Standard Oil Co. v. Comm'r, 77 T.C. 349, 409 (1981).
260. Rev. Rul. 65-79, 1965-1 C.B. 26.
261. 26 C.F.R. § 1.1031(a)-2(b)(1) (2004).
262. *Id.* § 1.1031(a)-2(b)(2).
263. Rev. Proc. 87-56, 1987-2 C.B. 674, 676-678. *See also* 26 C.F.R. § 1.1031(a)-2(b)(2) (2004).

e. automobiles and taxis;
f. buses;
g. light general purpose trucks;
h. heavy general purpose trucks;
i. railroad cars and locomotives, except those owned by railroad transportation companies;
j. tractor units for use over-the-road;
k. trailers and trailer-mounted containers;
l. vessels, barges, tugs, and similar water transportation equipment, except those used in marine construction; and
m. industrial steam and electric generation and/or distribution systems.[264]

Depreciable tangible personal property that is not classified with any general asset class has been classified into four digit product classes.[265] The Standard Industrial Classification ("SIC") Manual has been replaced by the North American Industry Classification Manual ("NAICS").[266] IRS released the guidance for using the NAICS Manual for federal income tax purposes on August 12, 2004.[267]

Properties within the same product class generally are of a like class.[268] Much of the personal property used in a farm business is included in product class 3523, Farm Machinery and Equipment under the SIC system.[269] Under the NAICS system, farm machinery and equipment are under product class 333111.[270] Under the NAICS system, product class 333111 specifically lists combines, cotton gin machinery, feed processing equipment, fertilizer equipment,

264. 26 C.F.R. § 1.1031(a)-(2)(b)(2) (2004).

265. *Id.* § 1.1031(a)-2(b)(3). *See* EXECUTIVE OFFICE OF THE PRESIDENT, OFFICE OF MANAGEMENT AND BUDGET, STANDARD INDUSTRIAL CLASSIFICATION MANUAL 427 (1987) [hereinafter "SIC"].

266. 13 C.F.R. § 121.101 (2005).

267. 26 C.F.R. § 1.1031(a)-2T(8)(d) (2004). The regulations adopt Sectors 31 through 33 of NAICS for defining product classes. The 2004 regulations apply to transfers on or after August 12, 2004, although taxpayers may apply the provisions to transfers of property on or after January 1, 1997, in taxable years for which the period of limitation has not expired. T.D. 9151, Temp. Treas. Reg. § 1.1031(a)-2T(d). The four-digit product class system can continue to be used until the regulations become final. *See* 26 C.F.R. § 1.1031(a)-2T(b)(8).

268. Treas. Reg. § 1.1031(a)-2(b)(1) (2004).

269. SIC, *supra* note 265 at 200.

270. EXECUTIVE OFFICE OF THE PRESIDENT, OFFICE OF MANAGEMENT AND BUDGET, NORTH AMERICAN INDUSTRY CLASSIFICATION SYSTEM 396 (2002) [hereinafter NAICS].

planters, plows, farm tractors, haying machinery, milking machines, and poultry feeding and watering equipment.[271]

Livestock of different sexes is not property of a like-kind.[272] Half-blood heifers (which were artificially inseminated) and three quarter blood heifers (which were the offspring of the artificially inseminated heifers) have been held to qualify as like-kind.[273] A trade of steer calves (which the court found were not held for sale in the ordinary course of business) for registered Aberdeen-Angus cattle has been held not to be a taxable exchange.[274] An exchange of cows with calves at side was considered like-kind but only 103 of 425 mixed yearlings were considered held for breeding purposes rather than for sale and thus were considered like-kind.[275] It is believed that exchange of a grade beef cow for a purebred registered beef cow would be like-kind. However, an exchange of a dairy cow for a beef cow apparently is not like-kind.

Some livestock SIC and NAICS classifications and their respective product class numbers are:

	SIC	NAICS
Beef cattle	0212	112111
Hogs	0213	112210
Dairy cattle	0241	112120
Sheep and goats	0214	112410
Horses	0272	112920
Rabbits and other fur-bearing animals	0271	112930[276]

2. *Problems with I.R.C. §§ 1245, 1250 Recapture in Like-Kind Exchanges*

If section 1245 property is disposed of in a like-kind exchange, section 1245 recapture must be recognized by the transferor to the extent of the amount

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271. *Id.* Thus, an exchange of farm machinery for farm machinery is like-kind.
272. I.R.C. § 1031(e) (2004); *see also* Treas. Reg. § 1.1031(e)-1 (2004).
273. Rutherford v. Comm'r, 37 T.C.M. (CCH) 1851-77 (1978).
274. Wylie v. United States, 68-1 U.S.T.C. (CCH) ¶ 9286, 86, 677 (N.D. Tex.1968).
275. Woodbury v. Comm'r, 49 T.C. 180, 197-99 (1967).
276. SIC, *supra* note 265 at 427; NAICS, *supra* note 270 at 396.

of gain recognized on the exchange plus the fair market value of property acquired that is not Section 1245 property.[277] The recapture of depreciation for section 1250 property is partially or fully deferred until there is a disposition of the acquired property.[278] For section 1250 property, recapture must be recognized to the extent of the larger of (1) the excess, if any, of the gain reported as ordinary income because of additional depreciation had the property been sold over the fair market value of the section 1250 property acquired or (2) any gain on the exchange.[279] The instructions for Form 8824, line 21, restate this rule and provide a location on the form for calculating the section 1245 and 1250 recapture ("ordinary income" under recapture rules) to the extent non-section 1245 and non-Section 1250 properties are received in exchange to the extent of additional depreciation.

3. *Whether a Partition is an Exchange*

a. *Exchanges Involving Related Parties*

If, within two years of a like-kind exchange of property with a related person, the related person disposes of the property, or the taxpayer disposes of the property, the gain is recognized.[280] Like-kind exchange treatment is denied for exchanges structured to avoid the related party rules.[281] A primary objective in enactment of the related party rules was to deny non-recognition treatment for transactions in which related parties make like-kind exchanges of high basis property for low basis property in anticipation of sale of the low basis property.[282] The related parties have, in effect, "cashed out" of the investment and the origin-

277. I.R.C. § 1245(b)(4) (2004); Treas. Reg. § 1.1245-4(d)(1) (2004).

278. I.R.C. § 1250(d)(4)(E) (2004).

279. I.R.C. § 1250(d)(4) (2004). *See also* Treas. Reg. § 1.1250-3(d) (2004).

280. I.R.C. § 1031(f)(1) (2004); Priv. Ltr. Rul. 2001-37-032 (Sept. 14, 2001) (exchanging of leasehold interest in cooperative corporation (with more than 30 years to run) for condominium interest was like-kind). *See* Rev. Rul. 2002-83, 2002-49 I.R.B. 927 (transferring of relinquished property to qualified intermediary in exchange for replacement property formerly owned by related party not entitled to non-recognition treatment if related party receives cash or other non like-kind property for replacement property).

281. I.R.C. § 1031(f)(4) (2004). *See also* Teruya Bros., Ltd. & Subsidiaries v. Comm'r, 124 T.C. No. 4 (2005).

282. *See* H.R. REP. NO. 101-247, at 1340 (1989).

nal exchange is not accorded non-recognition treatment.[283] However, the provision does not apply to dispositions involving the death of the taxpayer or the related person, a later compulsory or involuntary conversion, or situations where

the IRS is satisfied that avoidance of federal income tax is not a principal purpose of the transaction.[284] For this purpose, "related person" is as defined in I.R.C. §§ 267(b), 707(b)(1).[285] Routing the exchange through an unrelated party to avoid the related party rules does not avoid the denial of like-kind exchange treatment.[286] A transferor transferring like-kind property to a qualified intermediary in exchange for property owned by a related party must recognize gain if the related party receives cash or non like-kind property.[287]

b. *Whether a Partition Is an "Exchange"*

The regulations state that gain or loss is realized and recognized from the conversion of property into cash or from the exchange of property for other property different materially either in kind or extent.[288] Rulings issued indicate that gain or loss in a partition is not recognized unless a debt security (such as a

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283. *See* I.R.S. Field Serv. Adv. 1999-31-002 (Aug. 6, 1999) (involving a parent-children transaction). *See also* Tech. Adv. Mem. 2001-26-007 (June 29, 2001) (denying like-kind exchange treatment for multi-party exchange involving related parties where there was "basis shifting").

284. I.R.C. § 1031(f)(2) (2004). This exception includes transactions involving an exchange of undivided interests in different properties that result in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of the properties, dispositions of property in non-recognition transactions, and transactions that do not involve the shifting of basis between properties. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 206. The IRS has ruled that exchange of an undivided interest for a whole interest is not a "disposition" of property subject to the waiting period for related-party transactions. *See* Priv. Ltr. Rul. 1999-26-045 (Apr. 2, 1999) (stating that timber could be harvested within two-year period); Neil E. Harl, *Partition and the Related Party Rule*, 13 AGRIC. L. DIG. 145, 145 (2002).

285. *See* Priv. Ltr. Rul. 96-37-010 (Sept. 13, 1996) (finding that brother-sister corporations under I.R.C. § 267(f)(1) and loss deferral rules of I.R.C. § 267(f) apply).

286. *See* Tech. Adv. Mem. 97-48-006 (Nov. 28, 1997) (noting mere interposition of qualified intermediary between parties does not avoid related party rule).

287. Rev. Rul. 2002-83, 2002-49 I.R.B. 927. *See* Priv. Ltr. Rul. 2004-40-002 (Oct. 1, 2004) (finding deferred exchange involving like-kind property between related parties and gain not triggered and no "cashing out" of investment and also distinguishes Rev. Rul. 2002-83, 2002-49 I.R.B. 927).

288. Treas. Reg. § 1.1001-1(a) (2004).

promissory note) is received or property is received that differs "materially . . . in kind or extent" from the partitioned property.[289]

289. *See* Rev. Rul. 56-437, 1956-2 C.B. 507 (discussing conversion of stock in joint tenancy into tenancy in common); Priv. Ltr. Rul. 2003-28-034 (July 11, 2003) (concluding partition of tenancy-in-common property was not sale or exchange); Priv. Ltr. Rul. 2003-28-035 (July 11, 2003) (concluding partition of tenancy-in-common property was not sale or exchange). *See also* Rev. Rul. 73-476, 1973-2 C.B. 300 (recognizing no gain or loss from partition of real estate owned in tenancy in common); Rev. Rul. 79-44, 1979-1 C.B. 265, 266-67 (recognizing gain on partition of farmland only to extent one received a note equal to one-half outstanding mortgage); Priv. Ltr. Rul. 93-27-069 (July 9, 1993) (concluding gain or loss not recognized on partition of land); Priv. Ltr. Rul. 96-33-028 (Aug. 16, 1996) (concluding no gain or loss and not recognizing an exchange); Priv. Ltr. Rul. 2003-03-023 (Jan. 17, 2003) (recognizing no gain or loss on partitions of tenancy in common property interest); Priv. Ltr. Rul. 2004-11-022 (Mar. 12, 2004) (holding partition of tenancy in common property was not sale or exchange and applying Rev. Rul. 56-437, 1956-2 C.B. 507, rather than Rev. Rul. 73-476, 1973-2 C.B. 301); Priv. Ltr. Rul. 2004-11-023 (Mar. 12, 2004) (concluding partition of tenancy in common property was not sale or exchange).