12

AGRICULTURAL AND NATURAL RESOURCE TAX ISSUES

LEARNING OBJECTIVES

After completing this session, participants will be able to perform the following:

- ✔ Identify the factors that are used to classify a worker as an employee or independent contractor
- ✔ Understand an employer's tax liability for a misclassified worker, and when relief is available
- ✔ Recognize the agricultural payment programs for which payments may be excluded from the taxpayer's income under I.R.C. § 126
- ✔ Calculate the section 126 exclusion
- ✔ Know when amounts excluded under section 126 must be recaptured
- ✔ Understand when a farm trade or business commences
- ✔ Know when farming activities constitute a trade or business operated for profit
- ✔ Recognize the tax advantages and tax disadvantages of operating an agricultural business as an S corporation
- ✔ Know how to deduct expenses for a timber business
- ✔ Calculate the tax on a timber sale

INTRODUCTION

Misclassification of employees as independent contractors is a serious problem facing agricultural businesses and the broader economy. Under the Fair Labor Standards Act, misclassified workers are denied basic workplace protections, including rights to minimum wage and overtime pay. Employers may be liable for unpaid employment taxes. This section discusses new rules that are intended to help agricultural and other businesses properly classify a worker as an employee or an independent contractor.

Several state and federal government programs work to address farming and ranching conservation issues such as reducing soil erosion and protecting and improving water quality. Farm and ranch landowners may receive payments under certain federal or state cost-sharing conservation, reclamation, and restoration programs. This section discusses when the landowner can exclude the payments from gross income under I.R.C. § 126, how to calculate the excluded amount, and when the excluded amount must be recaptured.

Whether a taxpayer is engaged in the trade or business of farming determines the timing and allowance of deductions. If a taxpayer incurs expenses for a farming activity, but the trade or business has not yet started, the expenses are startup expenses. The current-year deduction for startup expenses is limited. If a taxpayer engages in a farming activity without a profit motive, the activity is a hobby, not a trade or business, and the expenses are not deductible. This chapter explains when a farm trade or business starts, and when farming activities are a trade or business, and not a hobby.

This chapter briefly reviews the formation of an S corporation, including eligibility requirements and the S corporation election. This chapter then reviews the tax advantages of operating an agricultural business as an S corporation, including the single level of tax, self-employment tax savings, and the qualified business income deduction. This chapter next discusses the tax disadvantages of operating as an S corporation, including possible gain on incorporation of a farming business with significant debt and depreciated assets and the corporate-level taxes that may apply to an S corporation with C corporation history. This chapter also explains the potential tax liability incurred by the estate or heirs of a deceased shareholder that sells appreciated corporate assets, and how a liquidation of the corporation in the same tax year can offset that gain.

Finally, this chapter explains important tax issues for forest landowners. It discusses basis, and treatment of expenses. It also reviews the tax treatment of a timber sale, and how the casualty loss rules apply to a timber casualty loss.

ISSUE 1: EMPLOYEE VS. INDEPENDENT CONTRACTOR

This section reviews the classification of a worker as an employee or an independent contractor.

Agriculture operations often have flexible arrangements with workers who may be part-time or seasonal workers. Agricultural business owners must correctly determine whether workers are employees or independent contractors to determine the tax treatment and reporting of payments to the workers and the applicability of state and federal employment laws.

In 2021, the U.S Department of Labor (DOL) published the Independent Contractor Status Under the Fair Labor Standards Act (2021 IC Rule). This rule was intended to provide guidance on classifying workers as employees or independent contractors under the Fair Labor Standards Act (FLSA). The 2021 IC Rule was a change from the economic reality test that DOL and the courts had continuously and consistently used.

In October 2022, DOL published a proposed rule that would rescind the 2021 IC Rule. The proposed rule uses a six-factor circumstance test to evaluate whether a worker is an employee or an independent contractor. This section reviews the general rules for worker classification and discusses the 2022 proposed rule. This section then explains problems that arise if an employee is misclassified as an independent contractor.

Common-Law Worker Classification Rules

An employee performs services for a business in which the employer has control over what will be done and how it will be done. A worker is typically an independent contractor if the payer has the right to control or direct only the result of the work and not what will be done and how it will be done. In examining whether an employee or independent contractor relationship exists, courts have considered the following three categories of evidence:

1. Behavioral control
2. Financial control
3. Relationship of the parties

Behavioral Control

Behavioral control considers whether an employer has the right to direct or control how the work is accomplished. An employer may exercise behavioral control by giving the following types of instruction:

- When and where to do the work
- What tools or equipment to use
- What workers to hire or to assist with the work
- Where to purchase supplies and services
- What work a specified individual must perform
- What order or sequence to follow when performing the work

Behavioral control also looks at the degree of instruction given to the worker. Generally, the more detailed the instructions, the more control the business exercises over the worker. More detailed instructions indicate that the worker is an employee. Less detailed instructions may indicate that the worker is an independent contractor.

Behavioral control factors also include an evaluation system and training. An evaluation system that measures the details of how the work is performed indicates that the worker is an employee. If the business provides the worker with training on how to do the job, this is also strong evidence that the worker is an employee.

Financial Control

Financial control looks at the economic aspects of the work. The financial control factors include the following:

1. *Significant investment*: An independent contractor often has a significant investment in the equipment he or she uses in working for someone else.
2. *Unreimbursed expenses*: Independent contractors are more likely to have unreimbursed expenses.
3. *Opportunity for profit or loss*: Having the possibility of realizing a profit or incurring a loss indicates that the worker is an independent contractor.
4. *Services available to the public*: An independent contractor is generally free to seek out business opportunities.
5. *Method of payment*: An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period.

Relationship of the Parties

Although a contract may show an intention to treat a worker as an employee or an independent contractor, this is not sufficient to determine the worker's status. Payment of employee benefits (e.g., insurance, pension plans, paid vacation, and sick days) may indicate an employment relationship. A continuous ongoing relationship suggests that the worker is an employee, while a project-based contract that ends at the conclusion of the work favors independent status.

Economic Reality Test

For more than 7 decades, the Department of Labor (DOL) and courts have applied an economic reality test to determine whether a worker is an employee or an independent contractor under the Fair Labor Standards Act (FLSA). The ultimate inquiry is whether, as a matter of economic reality, the worker is either economically dependent on the employer for work (and is thus an employee) or is in business for himself or herself (and is thus an independent contractor). To answer this ultimate inquiry of economic dependence, the courts and the DOL have historically conducted a totality-of-the-circumstances analysis, considering multiple factors to determine whether a worker is an employee or an independent contractor under the FLSA.

There is significant and widespread uniformity among the circuit courts in the application of the economic reality test, although there is slight variation as to the number of factors considered or how the factors are framed. These factors generally include the opportunity for profit or loss, investment by the worker and the employer, degree of permanency, the degree of control by the employer over the worker, whether the work is an integral part of the employer's business, and skill and initiative.

2022 Proposed Rule

On October 13, 2022, the DOL published a Notice of Proposed Rulemaking (the 2022 Proposed Rule) to revise the DOL's guidance on how to determine who is an employee or an independent contractor under the FLSA. The 2022 Proposed Rule would replace the 2021 IC Rule with an analysis for determining employee or independent contractor status that is more consistent with the FLSA, as interpreted by longstanding judicial precedent.

PRACTITIONER NOTE

Final Rule

The comment period on the Proposed Rule ended December 13, 2022. As of the time of this publication, the Proposed Rule has not been finalized.

The DOL believes that its 2022 Proposed Rule would reduce the risk that employees are misclassified as independent contractors, while providing added certainty for businesses that engage (or wish to engage) with individuals who are in business for themselves.

The 2022 Proposed Rule returns to a totality-of-the-circumstances analysis of the economic reality test in which the factors do not have a predetermined weight and are considered in view of the economic reality of the whole activity. The 2022 Proposed Rule sets forth the following six economic reality test factors:

1. Opportunity for profit or loss depending on managerial skill
2. Investments by the worker and the employer
3. Degree of permanence of the work relationship
4. Nature and degree of control
5. Extent to which the work performed is an integral part of the employer's business
6. Skill and initiative

PRACTITIONER NOTE

Purpose of the 2022 Proposed Rule

Although the 2022 Proposed Rule addresses only whether a worker is an employee or an independent contractor under the FLSA, the DOL assumes in this analysis that employers are likely to keep the status of most workers the same for all benefits and requirements, including for tax purposes.

Opportunity for Profit or Loss Depending on Managerial Skill

The opportunity for profit or loss depending on managerial skill factor considers whether the worker exercises managerial skill that affects the worker's economic success or failure in performing the work. The following may be relevant:

1. The ability to negotiate pay
2. The ability to accept or decline jobs
3. The right to choose the order or time in which jobs are completed, or hire other employees
4. Whether the worker engages in marketing, advertising, or other efforts to expand their business or secure more work
5. Whether the worker makes decisions to hire others, purchase materials and equipment, and/or rent space

If a worker has no opportunity for a profit or loss, then this factor suggests that the worker is an employee. Some decisions by a worker that can affect the amount of pay that a worker receives, such as the decision to work more hours or take more jobs, generally do not reflect the exercise of managerial skill indicating independent contractor status under this factor.

Example 12.1
Opportunity for Profit or Loss

John Davis is a carpenter in a rural town in Virginia. Last year, John started advertising his services at the local farmers cooperative. Alice MacDonald, who has a peanut farm, saw John's ad and hired him to build a barn and a farm stand. They negotiated a price, and John completed the work.

Now, Alice wants John to make repairs to her home and build a fence. John has other jobs, and he must decide whether to buy the necessary equipment to build a fence and hire another employee to do the work. John exercises managerial skill that affects his opportunity for profit or loss. John is an independent contractor.

Investments by the Worker and the Employer

The investments by the worker and employer factor considers whether any investments by a worker are capital or entrepreneurial. Costs that a worker pays to perform his or her job (e.g., tools and equipment to perform specific jobs and the workers' labor) are not evidence of a capital or entrepreneurial investment, and indicate employee status. Investments that are capital or entrepreneurial indicate independent contractor status.

Capital or entrepreneurial costs generally support an independent business and serve a business-like function, such as increasing the worker's ability to do different types of or more work, reducing costs, or extending market reach. Additionally, the worker's investments must be compared to the employer's investments in its overall business. The worker's investments do not have to be equal to the employer's investments, but the worker's investments should support an independent business or serve a business-like function for this factor to indicate independent contractor status.

Example 12.2
Nominal Worker Investments

Jenifer Cho is a certified crop adviser. She advises Southwest Farms, a commercial farming operation, about agronomic practices. The farm provides software, a computer, office space, and all Jenifer's equipment and tools. Jenifer occasionally uses her own supplies on the farm. Jenifer's relatively minor investment in supplies is not capital in nature and does little to further a business beyond the services that she provides to Southwest Farms. Her lack of a capital or entrepreneurial investment indicates that she is an employee.

Example 12.3
Extensive Worker Investments

The facts are the same as in Example 12.2 except that Jenifer only occasionally provides services for Southwest Farms, and she also markets her services to other farms. Most of the other farms that she is advising do not provide her with equipment or an office, so she has her own software, computer, and tools, and rents an office in a shared workspace. These types of investments support an independent business and are capital in nature (e.g., they allow Jenifer to do more work and extend her market reach). Thus, these facts indicate that Jenifer is in business for herself as an independent contractor.

Degree of Permanence of the Work Relationship

The degree of permanence of the work relationship factor indicates that the worker is an employee when the work relationship is indefinite in duration or continuous. This factor indicates that a worker is an independent contractor when the work relationship is definite in duration, nonexclusive, project-based, or sporadic because the worker is in business for himself or herself and marketing his or her services or labor to multiple entities.

A permanent work relationship may include regularly occurring fixed periods of work, such as seasonal or temporary agricultural work. However, where a lack of permanence is due to operational characteristics that are unique or intrinsic to a certain businesses or industries and the workers they employ, rather than the workers' own independent business initiative, this factor is not indicative of independent contractor status.

Example 12.4
Permanence of the Work Relationship

For 8 months each year, Lucas Bianchi is a field worker for Green Fields Production, a specialty crop farm in the southeast United States. He has worked for the farm for 5 years. Typically, the work starts in March with planting, and ends in October with harvesting. Lucas provides labor only for Green Fields, and he does not actively market his services to any other businesses. The farm provides his tools and equipment and supervises his work. In the winter months, Lucas provides handyman services around town. Even though Lucas does not work for Green Fields Production for the full calendar year, the recurring and exclusive nature of the work suggests that Lucas is an employee of the farm.

Nature and Degree of Control

The nature and degree of control factor considers the employer's control, including reserved control, over the performance of the work and the economic aspects of the working relationship.

More control by the employer favors employee status, and more control by the worker favors independent contractor status.

Facts relevant to the employer's control over the worker include whether the employer sets the worker's schedule, supervises the performance of the work, or explicitly limits the worker's ability to work for others. Additionally, facts relevant to the employer's control over the worker include whether the employer uses technological means of supervision (such as by means of a device or electronically), reserves the right to supervise or discipline workers, or places demands on workers' time that do not allow them to work for others or work when they choose.

Whether the employer controls economic aspects of the working relationship also considers who controls prices or rates for services and the marketing of the services or products that the worker provides. Control of a worker to comply with legal obligations, safety standards, or contractual or customer service standards may indicate that the worker is an employee.

Practitioner Note

Safety Training and Drug Testing

In *Parrish v. Premier Directional Drilling*, 917 F.3d 369 (5th Cir. 2019), the court considered whether workers at an oil drilling site were independent contractors or employees. The drilling company held safety training and conducted drug testing, but the court found that the training and testing was not dispositive of control because of the nature of the employment at an oil drilling site. The employer was responsible for providing a safe employment place and ensuring that workers complied with safety training, and drug testing was required for safe operations. Thus, the workers were not more economically dependent on the employer because of these safety requirements. The court concluded that these workers were independent contractors.

Extent to Which the Work Performed Is an Integral Part of the Employer's Business

The worker classification test considers whether the work performed is an integral part of the employer's business. This factor does not depend on whether any individual worker is an integral part of the business, but whether the function the worker performs is an integral part. If the employer could not function without the service performed by the workers, then the service they provide is integral.

This factor weighs in favor of the worker being an employee when the work that he or she performs is critical, necessary, or central to the employer's principal business. This factor weighs in favor of the worker being an independent contractor when the work that he or she performs is not critical, necessary, or central to the employer's principal business.

In most cases, if an employer's primary business is to make a product or provide a service, then the workers who are involved in making the product or providing the service are integral to the employer's business. An individual worker who performs the work that an employer is in business to provide, but who is just one of hundreds or thousands who perform the work, is nonetheless an integral part of the employer's business even if that one worker makes a minimal contribution to the business when considered among the workers as a whole.

Example 12.5
Farm Harvesters Are an Integral Part of the Business

Sun Gold Farms grows tomatoes that it sells to distributors. The farm pays workers to pick the tomatoes during the harvest season. Because picking tomatoes is an integral part of farming tomatoes, and the company is in the business of farming tomatoes, the tomato pickers are integral to the company's business. The integral part of the business factor indicates that these workers are employees.

Example 12.6
Farm Accountant Is Not an Integral Part of the Business

Sun Gold Farms pays an accountant to provide nonpayroll accounting support, including filing its annual tax return. This accounting support, while important, is not critical, necessary, or central to the principal business of the farm. Therefore, the integral part of the business factor indicates that the accountant is an independent contractor.

Skill and Initiative

The skill and initiative factor considers whether the worker uses specialized skills to perform the work and whether those skills contribute to business-like initiative. This factor indicates employee status where the worker does not use specialized skills in performing the work or where the worker is dependent on training from the employer to perform the work. Where the worker brings specialized skills to the work relationship, it is the worker's use of those specialized skills in connection with business-like initiative that indicates that the worker is an independent contractor.

That the work does not require prior experience, that the worker is dependent on training from the employer to perform the work, or that the work requires no training are indicators that the worker lacks specialized skills. Even if the worker possesses specialized skills, this factor may indicate employee status if the work does not require those skills.

Consistent with the principle that no one factor is dispositive, however, workers who lack specialized skills may be independent contractors even if this factor is very unlikely to point in that direction in their circumstances. A landscaper, for example, may perform work that does not require specialized skills, but application of the other factors may demonstrate that the landscaper is an independent contractor (e.g., the landscaper may have a meaningful role in determining the price charged for the work, make decisions affecting opportunity for profit or loss, determine the extent of capital investment, work for many clients, and/or perform work for clients for which landscaping is not integral).

Specialized skills possessed by carpenters, construction workers, and electricians are not themselves indicative of independent contractor status. Whether these workers take initiative to operate as independent businesses, as opposed to being economically dependent, suggests independent contractor status.

Example 12.7
Using Skills to Operate Independent Business

Gerald Jackson is a highly skilled welder. He routinely provides services for Blue Cow Dairy Farm, repairing equipment and machinery. Gerald provides welding services for several other businesses. He is technically skilled, but also uses and markets his skills in a manner that evidences business-like initiative. The skill and initiative factor indicates independent contractor status.

Additional Factors

Additional factors may be relevant in determining whether the worker is an employee or independent contractor for purposes of the FLSA, if the factors in some way indicate whether the worker is in business for himself or herself, as opposed to being economically dependent on the employer for work. To the extent facts such as the worker having a business license or being incorporated may suggest that the worker is in business for himself or herself, they may be considered either as an additional factor or under any enumerated factor to which they are relevant. However, this factor must consider whether the worker's license or incorporation demonstrates that the worker is in business for himself or herself as a matter of economic reality. For example, if an employer requires a worker to obtain a certain license or adopt a certain form of business to perform work for it, this may be evidence of the employer's control, rather than a worker who is independently operating a business.

Worker Classification

Correct classification of a worker as an independent contractor or an employee is important to comply with the FLSA wage and hour requirements. It is also essential to income and employment tax withholding and deposit requirements.

Fair Labor Standards Act

Congress enacted the FLSA in 1938 to eliminate labor conditions that are detrimental to the maintenance of the minimum standard of living necessary for health, efficiency, and general well-being of workers. The FLSA generally requires covered employers to pay nonexempt employees at least the federal minimum wage for all hours worked and at least one and one-half times the employee's regular rate of pay for every hour worked over 40 in a workweek. The FLSA also requires covered employers to maintain certain records regarding employees and prohibits retaliation against employees who are discharged or discriminated against after, for example, inquiring about their pay or filing a complaint with the DOL. The FLSA's minimum wage, overtime pay, and other protections do not apply to independent contractors.

Practitioner Note

Other Employee Benefits

Classification of a worker as an independent contractor is also important to determine eligibility for participation in retirement plans, availability of certain fringe benefits, workers' compensation requirements, and compliance with other state and federal employment laws.

Income and Employment Tax

Typically, an employer must withhold and deposit income taxes, social security taxes, and Medicare taxes from the wages paid to an employee. Additionally, the employer must pay the matching employer portion of social security and Medicare taxes and pay unemployment tax on wages paid to an employee. Generally, an employer does not have to withhold or pay any taxes on payments to independent contractors.

A business that misclassifies an employee as an independent contractor can be held liable for income taxes and employment taxes for that worker. If the business disregards the reporting requirements for the worker, the employer's liability increases [I.R.C. § 3509]. Limited relief may apply (discussed later).

Form SS-8

If a business cannot determine whether a worker qualifies as an independent contractor after weighing the facts and circumstances, either the business or the worker can file Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, to request a ruling. There is no fee, but the determination can take several months.

The IRS will acknowledge the receipt of Form SS-8 and attempt to get information from the business and the worker. Some or all the information provided on Form SS-8 may be shared with the other parties listed on page 1 of the form. The case is assigned to a technician who reviews the facts, applies the law, and renders a decision.

The IRS will generally issue a formal determination to the business and sends a copy to the worker. A determination letter applies only to a worker (or a class of workers) requesting it, and the decision is binding on the IRS if there is no change in the facts or law that form the basis for the ruling. In certain cases, the IRS will not issue a formal determination, but will issue an information letter instead. An information letter is advisory only, and is not binding on the IRS, but a worker may use the letter in fulfilling his or her federal tax obligations.

Section 530 Relief

I.R.C. § 530 provides employers with relief from the reclassification of workers as employees, and the corresponding federal employment tax liabilities if the following three requirements are met:

1. *Reporting consistency*: The taxpayer must have filed all federal tax returns (including information returns) required to be filed with respect to the individual for the period on a basis consistent with the taxpayer's treatment of the individual as a nonemployee. This test must be applied to each worker separately, because, for example, the taxpayer may have filed a Form 1099 for one worker in a class, but not for another worker in the same class.
2. *Substantive consistency*: The taxpayer must have treated similarly situated workers consistently. That is, if the taxpayer (or a predecessor) treated a similarly situated worker as an employee, the taxpayer will not be entitled to section 530 relief. This test must be applied to the class of workers having substantially similar job responsibilities and working under substantially similar conditions (e.g., supervisors vs. workers being supervised).
3. *Reasonable basis*: The taxpayer must have had some reasonable basis for treating the worker as a nonemployee. This may consist of reasonable reliance on a judicial precedent, a published ruling, a private letter ruling or technical advice memorandum issued to the taxpayer; the results of an employment tax audit of the taxpayer that takes place after 1996 (Note*:* An audit prior to 1997 can still qualify the taxpayer for the prior audit safe haven); or a long-standing recognized practice of a significant segment of the industry in which the worker is engaged. Any other reasonable basis could also suffice. This requirement is applied separately to each class of workers.

If the business clearly meets the reporting and substantive consistency requirements and satisfies the reasonable basis test, the section 530 requirements are fully met. As a result, no adjustment is made, and the taxpayer may choose to continue treating its workers as nonemployees for purposes of its employment tax liability if the facts remain the same and the taxpayer continues to meet the reporting requirements for that class of worker.

Voluntary Classification Settlement Program

The Voluntary Classification Settlement Program (VCSP) is an optional program that provides taxpayers with an opportunity to reclassify their workers as employees for future tax periods for employment tax purposes. The program grants partial relief from federal employment taxes for eligible taxpayers that agree to prospectively treat their workers (or a class or group of workers) as employees.

To participate in this voluntary program, the taxpayer must meet the following eligibility requirements:

1. The taxpayer must have consistently treated the workers as independent contractors or other nonemployees, including having filed all required Forms 1099 for the workers to be reclassified under the VCSP for the previous 3 years.
2. The taxpayer cannot currently be under an IRS employment tax audit or a DOL or state government agency audit concerning the classification of the workers. If the IRS or the DOL previously audited a taxpayer concerning the classification of the workers, the taxpayer will be eligible only if the taxpayer has complied with the results of that audit and is not currently contesting the classification in court.

Taxpayers apply to participate in the VCSP by filing Form 8952, Application for Voluntary Classification Settlement Program. The taxpayer should file the application at least 60 days prior to the date the taxpayer wants to begin treating its workers as employees. Eligible taxpayers accepted into the VCSP enter into a closing agreement with the IRS to finalize the terms of the VCSP and must simultaneously make full and complete payment of any amount due under the closing agreement.

Practitioner Note

Employment Tax Examination

If the taxpayer is currently under an employment tax audit, and the IRS examiner has fully developed the worker classification issue and determined that section 530 relief does not apply, the examiner must present a classification settlement program (CSP) offer to an eligible taxpayer. A CSP is available to taxpayers with an open employment tax examination in SB/SE, TE/GE, LB&I, and Appeals. The taxpayer must have timely filed all required Forms 1099. Taxpayers that have not timely filed the required information returns cannot participate in the CSP for any years for which the returns were not timely filed [see I.R.M. § 4.23.6].

ISSUE 2: COST-SHARING EXCLUSION

The I.R.C. §126 cost-sharing exclusion allows the taxpayer to exclude certain agricultural program payments from gross income.

Generally, if a state or federal government agency pays the costs of a conservation project on a farmer's land, those payments are reported as income to the farmer in the year received. However, I.R.C. § 126 provides that recipients of payments under certain conservation, reclamation, and restoration programs may exclude all or a portion of those payments from income if the payments do not substantially increase the annual income the taxpayer derives from the affected property.

To qualify for the exclusion, the payments must be made for capital improvements. The payments cannot be made for rent, services, or other deductible amounts. There is no basis adjustment for acquisition or improvement costs paid with excluded amounts. Thus, section 126 is helpful if the government payment is higher than the increase in the property's value because of the improvement. The exclusion is also beneficial if the asset's allowable depreciation is less than the cost-sharing payment received.

This section discusses the programs that may qualify for the section 126 exclusion and the requirements for the exclusion. Finally, this section gives an example of how to calculate the income from the improvement, which is necessary to determine the exclusion amount.

Qualifying Programs

I.R.C. § 126(a) provides that a taxpayer's gross income does not include the excludable portion of payments received from the following programs:

1. The rural clean water program authorized by section 208(j) of the Federal Water Pollution Control Act [33 U.S.C. § 1288(j)]
2. The rural abandoned mine program authorized by section 406 of the Surface Mining Control and Reclamation Act of 1977 [30 U.S.C. § 1236]
3. The water bank program authorized by the Water Bank Act [16 U.S.C. § 1301 et seq.]
4. The emergency conservation measures program authorized by title IV of the Agricultural Credit Act of 1978
5. The agricultural conservation program authorized by the Soil Conservation and Domestic Allotment Act [16 U.S.C. § 590a]
6. The resource conservation and development program authorized by the Bankhead-Jones Farm Tenant Act and by the Soil Conservation and Domestic Allotment Act [7 U.S.C. § 1010; 16 U.S.C. § 590a et seq.]
7. Any small watershed program administered by the USDA if the IRS determines that it is substantially similar to the type of programs described in 1– (discussed next)
8. Any program of a state, possession of the United States, a political subdivision of any of the foregoing, or the District of Columbia under which payments are made to individuals primarily for the purpose of conserving soil, protecting, or restoring the environment, improving forests, or providing a habitat for wildlife

Small Watershed Programs

The IRS has determined that certain small watershed programs are eligible programs if the payments meet all the other eligibility requirements. This section discusses the following programs:

- Environmental Quality Incentives Program [Federal Agricultural Improvement and Reform Act of 1996; Rev. Rul. 97-55, 1997-2 C.B. 20]
- Conservation Stewardship Program [Rev. Rul. 2006-46, 2006-2 C.B. 511]

- Conservation Reserve Program [Rev. Rul. 2003-59, 2003-1 C.B. 1014]
- Agricultural Management Assistance Program [Rev. Rul. 2003-15, 2003-1 C.B. 303]

This section also lists several other small watershed programs from which payments may be eligible for the section 126 exclusion.

Environmental Quality Incentives Program

The Environmental Quality Incentives Program (EQIP) provides farmers with financial and technical assistance for working lands, including field crops, specialty crops, organic, confined livestock and grazing, and nonindustrial private forest land. Any land on which agricultural commodities, livestock, or forest-related products are produced is eligible land. EQIP offers payments for practices and activities that help farmers maintain or improve production while conserving natural resources.

EQIP combines the functions of the following four prior USDA programs:

1. Agricultural Conservation Program
2. Water Quality Incentives Program
3. Great Plains Conservation Program
4. Colorado River Basin Salinity Control Program

In 2022, the National Resources Conservation Service (NRCS) expanded the Environmental Quality Incentives Program Conservation Incentive Contract (EQIP CIC) nationwide. EQIP CIC has a 5-year contract with implementation payments and annual management payments. NRCS calls this hybrid program a "stepping-stone" for farmers who want to transition from correcting resource issues on specific land units through EQIP, to achieving sustainable stewardship on their entire operation through the Conservation Stewardship Program.

Rev. Rul. 97-55 concludes that the EQIP is substantially similar to the type of programs described in section 126(a)(1) through (7), and cost-share payments made under the program and in connection with small watersheds are within the scope of section 126(a)(8). Thus, these cost-share payments are eligible for exclusion from gross income to the extent permitted by section 126.

Conservation Stewardship Program

The USDA's Conservation Stewardship Program (previously called the Conservation Security Program) (CSP) offers technical and financial assistance to help agricultural and forest producers maintain existing conservation practices, and design and implement new conservation practices. CSP contracts are for 5 years, with an option to renew. The CSP enrolls the entire operation in the program, not just one specific field or tract.

NRCS typically accepts applications for the CSP on a continuous basis. Deadlines are announced as funds become available. CSP contracts vary significantly, but the minimum contract payment is $1,500 per year. Some payments are cost-share reimbursement for conservation improvements. There are also supplemental payments that seek to incentivize farmers to implement certain conservation activities, such as enhanced cover crops or reduced tillage.

Rev. Rul. 2006-46 concludes that the CSP is a small watershed program. Payments for practices included in the existing practice and new practice components are limited to a percentage of the average county costs of the practices and qualify as cost-share payments. The cost-share payments received under the existing practice and new practice components of the CSP are eligible for exclusion from gross income to the extent permitted by section 126.

Payments under the stewardship component are based on the rental rate applicable to the land and are not cost-share payments that are excludable from gross income. Payments under the enhancement component qualify as cost-share payments if they are based on an activity's cost rather than on its expected conservation benefits. Payments under the enhancement component based on the activity's expected conservation benefits rather than on its cost are not cost-share payments and are included in gross income [Rev. Rul. 2006-46].

Conservation Reserve Program

Landowners who participate in the Conservation Reserve Program (CRP) enter into one or more 10-to-15-year contracts with the USDA. They receive annual payments for removing environmentally sensitive land from agricultural production and planting species that will improve environmental health and quality. The income from these annual payments is not eligible for the section 126 exclusion.

The Conservation Reserve Enhancement Program (CREP) is a part of the CRP. The CREP provides cost-share payments to farmers and ranchers to implement approved conservation-related practices. Possible conservation practices that can be implemented include riparian buffers, filter strips, wetlands, and pollinator plantings.

Rev. Rul. 2003-59 holds that the cost-share payments are eligible for exclusion from gross income under section 126. Rental payments and incentive payments are not cost-share payments and are included in gross income.

Agricultural Management Assistance Program

The Agricultural Management Assistance (AMA) program supports producers who construct or improve water management structures or irrigation structures; plant trees for windbreaks or to improve water quality; and mitigate risk through production diversification or resource conservation practices, including soil erosion control, integrated pest management, or transition to organic farming. AMA is available in 16 states where participation in the Federal Crop Insurance Program is historically low: Connecticut, Delaware, Hawaii, Maine, Maryland, Massachusetts, Nevada, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, Utah, Vermont, West Virginia, and Wyoming. AMA provides financial assistance of up to 75% of the cost of installing conservation practices.

In Rev. Rul. 2003-15, the IRS concludes that AMA is a small watershed program. Cost-share payments received under the AMA may be eligible for exclusion from gross income to the extent permitted by section 126.

Other Eligible Programs

Payments under the following programs may also be eligible for the section 126 cost-sharing exclusion:

- Programs under the Watershed Protection and Flood Prevention Act
- Flood prevention projects under the Flood Control Act of 1944
- The Emergency Watershed Protection Program
- Certain programs under the Colorado River Basin Salinity Control Act
- The Wetlands Reserve Program (replaced by the Agricultural Conservation Easement Program)
- The Soil and Water Conservation Assistance Program
- The Forest Land Enhancement Program
- The Forest Health Protection Program
- The Small Watershed Program
- The Emergency Conservation Program

Section 126 Eligibility

To be eligible for the section 126 income exclusion, cost-sharing payments under an eligible program must meet the following requirements:

1. The secretary of Agriculture must determine that the payment was made primarily for conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.
2. The secretary of the Treasury must determine that the payments do not substantially increase the annual income that the taxpayer derives from the affected property.
3. The cost-sharing payment must be for capital improvements. No portion of the payment can be excluded if the payment is for a deductible expense.

Amount of the Exclusion

Under Treas. Reg. § 16A.126-1, the taxpayer can claim the section 126 exclusion for all or a portion of eligible payments that do not substantially increase the annual income derived by the taxpayer from the affected property. An increase in annual income is substantial if it exceeds the greater of

- 10% of the average annual income (gross receipts) derived from the affected property for the 3 tax years before the tax year in which installation of the improvement commences, or
- $2.50 times the number of affected acres.

The gross income realized on receipt of the section 126 improvement is the value of the section 126 improvement less the sum of the taxpayer's share of the cost of the improvement and the excludable portion.

Value of the Improvement

The value of the improvement is calculated by multiplying the fair market value (FMV) of the improvement (the amount by which the improvement increases the farm's value) by a fraction. The numerator of the fraction is the section 126 cost, which is that part that has been certified to be primarily for conservation. The denominator of the fraction is the total cost of the improvement.

Excludable Portion

Excludable portion means the amount by which eligible payments do not substantially increase the annual income derived by the taxpayer from the affected property. Thus, it is the present FMV of the right to receive annual income from the affected acreage that does not exceed the greater of 10% of the 3 prior years' average annual income from the affected acreage or $2.50 times the number of affected acres.

Affected Acres

Affected acreage means the acres affected by the improvement. The larger the area defined, the greater the income exclusion amount.

PLANNING POINTER

Nonfarming and Timber Landowners

Section 126 applies to operating farmers, crop share, cash rent landowners, and rural nonfarming landowners. Because nonfarming and timber landowners do not qualify for the I.R.C. § 175 soil and water conservation expenditures deduction, they may be eligible to exclude income under section 126 for nondepreciable improvements and depreciable capital assets.

Example 12.8
Income Exclusion Calculation

Juan Velasquez owns a 300-acre farm in Wisconsin. In 2023, Juan participated in a cost-share program with the USDA. He installed a concrete stabilization structure to prevent erosion. The program paid Juan $45,000 of the $50,000 cost of the erosion structure. The improvement is entirely for conservation purposes.

Juan's average annual gross farm income for the 3 preceding tax years (2020, 2021, and 2022) is $180,000 per year. Twenty acres of his farm are affected by the erosion control structure. The erosion control structure is a capital improvement, and it increased the value of the farm by $40,000. The cost-share program meets all the section 126 requirements.

Juan must first calculate his cost-share income excludable portion, which is the present value of the greater of $1,200 [10% × (20 acres ÷ 300 acres) × $180,000)] or $50 ($2.50 × 20 acres). Assuming a 4% discount rate, the excludable portion is $30,000 ($1,200 ÷ 4%). Juan's $5,000 income realized on the improvement is calculated in **Figure 12.1**.

FIGURE 12.1
Income Realized on the Improvement

Value of improvement	$40,000
Taxpayer's share of the cost	(5,000)
Excludable portion	(30,000)
Amount included in income	$ 5,000

Reporting Requirements

The income exclusion is automatic for taxpayers who qualify. However, the taxpayer can elect to include the payments. Taxpayers claiming the exclusion must attach a statement to their tax return for the year in which the last payment is made. The statement must include the following:

1. The dollar amount of the government payment
2. The value of the improvement
3. The amount of the payment the taxpayer is excluding

Total cost-share payments are reported on Schedule F (Form 1040), Profit or Loss From Farming, line 4a, and the taxable amount is reported on line 4b. The amount excluded from income is not added to the basis of the land. However, taxpayers may add to basis the total costs of the improvement that are included in income [Rev. Rul. 84-67, 1984-1 C.B. 28]. No deduction or credit is allowed for an excluded expenditure.

If a taxpayer elects to not exclude the cost-share payment from income, the payment is income to the taxpayer in the year received and the cost-share amount is added to the basis of the affected property. Taxpayers electing to not exclude any or all of the payments received under a qualified program must make the election by the due date, including extensions, for filing the return for the tax year in which the payment was received or accrued [I.R.C. § 126(c)]. If the taxpayer timely filed a return for the year without making the election, the taxpayer may amend the return within 6 months of the return's due date (excluding extensions) by writing "Filed pursuant to section 301.9100-2" at the top of the amended return.

Recapture of Exclusion

Some or all the section 126 income exclusion may be subject to recapture as ordinary income if the taxpayer sells or otherwise disposes of the property for a gain within 20 years of receiving the excluded payment [I.R.C. § 1255]. If the property is sold within a 10-year period, the applicable percentage is 100%, and all the excluded portion is reported as ordinary income (to the extent of gain on the sale).

If the property is sold more than 10 years after the payment is received, the applicable percentage is reduced by 10% (but not below 0%) for each year or part of a year that the property is held for more than 10 years. For example, if there is a sale in the fifteenth year, the lesser of the gain or 50% of the excluded payment is treated as ordinary income. Sale and recapture amounts are reported on Form 4797, Sales of Business Property, Part III.

Example 12.9
Calculating the Recapture

Dakota Norwood is a calendar-year taxpayer. On April 10, 2023, Dakota sold ranch property that was section 126 property. Her adjusted basis was $52,500, and she sold the property for $75,000. She realized a $22,500 ($75,000 – $52,500) gain. The excludable portion under section 126 was $18,000. Dakota received the section 126 payment on January 5, 2018.

No gain is recognized as ordinary gain under I.R.C. §§ 1231 through 1254. The applicable recapture percentage is 100% of the $18,000 excludable portion. Because the $18,000 excludable portion is less than the $22,500 gain realized, the amount of Dakota's gain recognized as ordinary income under section 1255(a)(1) is $18,000. The remaining $4,500 ($22,500 – $18,000) gain may be treated as I.R.C. § 1231 gain [Treas. Reg. 16A.1255-1(d), Example].

Practitioner Note

Dispositions by Gift or Death

Special recapture rules apply to a disposition by gift or death. In general, there is no section 1255 gain on a gift of section 126 property. The recapture amount (the excluded portion) carries over to the donee. Except with regard to income in respect of a decedent, there is no section 1255 gain on a transfer at death. If the person who acquires section 126 property from the decedent receives a date-of-death basis adjustment (or an adjustment based on the alternate valuation date), then the transferee's excludable section 126 portion is zero. Special rules also apply to certain tax-free transactions. [See Treas. Reg. § 16A.1255-2.]

ISSUE 3: FARM TRADE OR BUSINESS

This section discusses when a farm business begins and what constitutes a farming business operated for profit.

Whether a taxpayer is engaged in the trade or business of farming determines the timing and allowance of deductions. If a taxpayer incurs expenses for a farming activity, but the trade or business has not yet started, the expenses are startup expenses. The current-year deduction for startup expenses is limited. If a taxpayer engages in a farming activity without a profit motive, the activity is a hobby, not a trade or business, and the expenses are not deductible under current law. This section explains when a farm trade or business starts, and when farming activities are a trade or business, and not a hobby.

Start of a Farm Trade or Business

Generally, the determination of whether a taxpayer's activities constitute a trade or business requires an examination of the facts and circumstances of each case. The activities must be regular and continuous, and they must be conducted for the purpose of earning a profit. A sporadic activity, hobby, or an amusement diversion does not qualify as a trade or business [*Commissioner v. Groetzinger*, 480 U.S. 23 (1987)].

Practitioner Note

Definition of Farming

Tax law defines farm in the ordinarily accepted sense [Treas. Reg. § 1.61-4(d)]. It includes stock, dairy, poultry, fruit, and truck farms, as well as plantations, ranches, and all land used for farming operations. The definition of farmers includes individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants. A taxpayer is engaged in the business of farming if he or she cultivates, operates, or manages a farm for gain or profit, either as an owner or a tenant [Treas. Reg. § 1.175-3]. Whether gross income is earned from farming determines, for example, whether the taxpayer is eligible for farm income averaging [I.R.C. § 1301], whether special estimated tax rules apply [I.R.C. § 6654], and whether the taxpayer is eligible to deduct conservation expenses [I.R.C. § 175] or fertilizer expenses [I.R.C. § 180]. Different definitions apply in other contexts.

A taxpayer has not engaged in carrying on a trade or business until such time as the business has started to function as a going concern and perform the activities for which it was organized [*Antonyan v. Commissioner*, T.C. Memo. 2021-138]. Until that time, expenses are not ordinary and necessary expenses that are presently deductible under I.R.C. § 162 (or I.R.C. § 212 for income producing activity). They are startup expenses, subject to the I.R.C. § 195 rules.

Practitioner Note

Startup Expenses

Under section 195, in the tax year in which the active trade or business begins, the taxpayer can deduct up to $5,000 of startup expenditures, reduced by the amount by which those expenditures exceed $50,000. The remainder is allowable as a deduction ratably over the 180-month period beginning with the month in which the active trade or business begins.

Carrying on a trade or business requires a showing of more than initial research or investigation of business potential. The business operations must have actually started. Whether an expenditure satisfies the requirements of section 162 is a question of fact. Courts have focused on the following three factors to determine whether a taxpayer is engaged in a trade or business:

1. Whether the taxpayer undertook the activity intending to earn a profit
2. Whether the taxpayer is regularly and actively involved in the activity
3. Whether the taxpayer's activity has actually commenced

For expenses to be deductible under section 162, the taxpayer must demonstrate that the predominant, primary, or principal objective in engaging in the activity is to earn a profit [*Wolf v. Commissioner*, 4 F.3d 709 (9th Cir. 1993)]. A planned farm must reach a productive state before the taxpayer can deduct trade or business expenses.

Example 12.10
Beginning a Farm Trade or Business

James Primus acquired rural property with maple trees, hay fields, and 12 acres that were suitable for growing crops. He planned to produce maple syrup. Although the trees were large enough to produce sap, he wanted to thin the trees so that they would produce better sap. He began thinning the maple bush and continued that activity for multiple years. During this same time, James also decided to produce blueberries. He cleared the areas where he planned to plant blueberry bushes, but did not plant them.

James's expenses are startup expenses that are not deductible under section 162 because his business is not actually functioning and performing the activities for which it was organized. While cultivation of plants is an essential part of a trade or business involving production of commodities from those crops, cultivation, without more, is not sufficient to show that the activity has progressed past the startup phase. Preparing a property to produce a commodity (such as maple syrup or blueberries) is not a trade or business or income-producing activity before sap is collected or blueberry bushes are planted [*Primus v. Commissioner*, T.C. Summary Opinion 2020-2].

Farm Operated for Profit

If a farm is operated for recreation or pleasure and not on a commercial basis, the taxpayer is not operating a trade or business, and the associated expenses are not deductible. To deduct expenses, the taxpayer must be engaged in the activity with the intent to make a profit. A taxpayer conducts an activity for profit if he or she does so with an actual and honest profit objective. Profit means economic profit, independent of tax savings.

This section reviews the factors that are considered to determine whether an activity is a trade or business. It then discusses several court cases that apply the factors to farming activities. Finally, this section explains presumption, election, and hobby loss rules.

Hobby Factors

The determination of whether an activity is engaged in for profit is made by reference to objective standards, considering all the facts and circumstances of each case. IRS Publication 5558, *Activities Not Engaged in for Profit Audit Technique Guide* (Revised 9/07/2021), acknowledges that this is often a difficult determination:

> An activity not engaged in for profit examination is both extensive and challenging because of the infinite variations of fact patterns and regulations which are quite often vague. Even for tax scholars, it can often prove highly difficult to figure out the difference between a legitimate business that is devoted to making a profit and an activity that is not.

Objective factors are given more weight than a taxpayer's mere statement of intent [Treas. Reg. § 1.183-2(a)]. The following nine nonexclusive factors may be relevant to determine whether a taxpayer operates a farm for a profit:

1. The manner in which the taxpayer carries on the activity
2. The expertise of the taxpayer or his or her advisers
3. The time and effort expended by the taxpayer in carrying on the activity
4. The expectation that the assets used in the activity may appreciate in value
5. The success of the taxpayer in carrying on other similar or dissimilar activities
6. The taxpayer's history of income or losses with respect to the activity
7. The amount of occasional profits earned, if any
8. The financial status of the taxpayer
9. Whether elements of personal pleasure or recreation are involved

[Treas. Reg. § 1.183-2(b)]

The taxpayer bears the burden of proving that he or she engaged in the activity with an actual and honest objective of realizing a profit. Courts apply the nine factors to the facts and circumstances of each case and determine whether the taxpayer has demonstrated that he or she engaged in the activity primarily to make a profit [*Donoghue v. Commissioner*, T.C. Memo. 2019-71].

Manner in Which the Taxpayer Carries on the Activity

Conducting an activity in a businesslike manner may indicate a profit motive. Considerations include whether the taxpayer

1. maintained complete and accurate books and records for the activity;
2. prepared a business plan;
3. conducted the activity in a manner that is substantially similar to comparable activities that were profitable;
4. changed operating procedures, adopted new techniques, or abandoned unprofitable methods in a manner consistent with an intent to improve profitability; and
5. in the case of horse breeding and sales, ran a consistent and concentrated advertising program.

Expertise of the Taxpayer and Advisers

A taxpayer's own expertise, research, and extensive study of an activity, or consultation with experts, may indicate a profit motive. Courts consider whether the taxpayer received advice from experts regarding the accepted principles and economics of profitably running a business, and whether the taxpayer conducted the activities in accordance with the adviser's advice.

Time and Effort Devoted to the Activity

A taxpayer that devotes much of his or her personal time and effort to carrying on an activity may indicate a profit objective, particularly if the activity does not involve substantial personal or recreational aspects. However, a taxpayer that devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.

Expectation that the Assets Used in the Activity May Appreciate in Value

An expectation that assets used in the activity will appreciate in value and may produce an overall profit may indicate a profit motive, even if the taxpayer derives no operational profit. A profit objective may be inferred from the expected appreciation of assets only where the appreciation exceeds operating expenses and would be sufficient to recoup accumulated losses of prior years. A vague notion that assets are appreciating in value does not constitute a bona fide expectation.

Multiple Activities

If a taxpayer engages in two or more separate activities, deductions and income from each separate activity are not aggregated in determining whether a particular activity is engaged in for profit. However, multiple activities may be treated as one activity if the activities are sufficiently interconnected. The most significant facts and circumstances in making this determination are the degree of organizational and economic interrelationship of various activities, the business purpose that is served by carrying on the various activities separately or together in a trade or business or in an investment setting, and the similarity of various activities.

Farmland Appreciation

If the taxpayer purchases farmland with the intent to profit from its appreciation and the taxpayer also farms on the land, the farming and the holding of the land are usually considered to be a single activity if the farming activity reduces the net cost of carrying the land for its appreciation. The purpose of this regulation is to prevent taxpayers who are engaged in farming activities from offsetting farming losses with land appreciation.

Farming and holding the land is considered a single activity if the income from farming exceeds the farming expenses that are not directly attributable to the holding of the land. Deductions other than those directly attributable to the holding of the land include interest on a mortgage secured by the land, property taxes attributable to the land, improvements to the land, and depreciation of improvements to the land [Treas. Reg. § 1.183-1(d)].

Success of Taxpayer in Carrying on Other or Similar Activities

A taxpayer that may have engaged in similar activities and turned them into profitable enterprises may indicate that the taxpayer is engaging in the present activity for a profit, even if it is currently unprofitable.

History of Income or Losses with Respect to the Activity

A taxpayer's history of income or losses with respect to an activity may indicate the presence or absence of a profit motive. A series of losses during the initial or startup stage of the activity does not necessarily mean that the activity is a hobby activity, but losses extending beyond the customary startup stage may indicate that the activity is not engaged in for profit. The taxpayer's objective must be to realize a profit on the entire operation, which includes sufficient net earnings to recoup losses incurred to make the activities profitable.

Amount of Occasional Profits Earned, If Any

The amount of profits, in relation to losses, may indicate a taxpayer's intent. A taxpayer's belief, if adequately supported, that he or she may earn a substantial profit from the activity may indicate a profit objective. An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, is generally not determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally indicate that an activity is engaged in for profit, where the investment or losses are comparatively small.

Financial Status of the Taxpayer

A taxpayer's lack of substantial income from other sources may indicate that the taxpayer is engaging in the activity for a profit. However, substantial income from another source could indicate that the activity is not for profit, particularly if the losses from the activity offset significant income from another activity.

Elements of Personal Pleasure or Recreation

The existence of personal motives or recreational elements in an activity may indicate that the activity is not engaged in with a profit motive. A business is not a hobby just because a taxpayer finds it pleasurable, but if the likelihood of profit is small compared to the potential for personal gratification or enjoyment, the latter may be the primary motive for the activity.

Farm Cases

Many hobby loss cases involve racehorse breeding. The IRS has historically won these cases, which usually involve wealthy landowners seeking to offset high income with large losses. In cases that analyze more traditional farming activities, courts note that extended periods of loss are not sufficient to establish the lack of a profit motive.

Farming, especially, is an activity in which sustained losses are not unusual. It is the expectation of gain, and not gain itself that is one of the factors that determines a profit motive [*Hoyle v. Commissioner*, T.C. Memo. 1994-592]. In evaluating whether a farmer had a profit motive, courts have considered whether the taxpayer maintained business records and separate bank accounts, sought expert advice, obtained little or no recreational benefit from the farm, and changed activities to increase profitability. The following examples are based on these court rulings.

Example 12.11
Expectation of Future Farm Profit

W. Clark Wise owned part of an automobile dealership. He purchased a 42-acre farm with a house, a barn, and other farm buildings. Clark remodeled the house and rented it, reroofed the barn, repaired the fence, and painted the barn and the outbuildings. A year later, Clark purchased a tractor, truck, and other equipment and supplies. He planted wheat, corn, and oats and purchased and sold cattle. The farm never produced a profit. Clark's family consumed 13% of the produce. The IRS denied Clark's farm losses.

Although the overall farming activity generated only losses, Clark's objective was to rebuild the farm and make it profitable. He spent time laboring on the farm and generally supervising its operation. He raised grain crops and derived income from the sale. He kept an accurate account of his income and expense.

The failure of the farm to show a profit was largely because of its size and poor condition. There were no recreational facilities on the farm, and it was not used in that manner by Clark's family (except for occasional hunting). Clark demonstrated that his farm will, in due course, show a profit [*W. Clark Wise*, T.C. Memo. 1957-83].

Example 12.12
Significant Time and Attention

Walter E. Edge, Jr. owned and operated a farm in Florida. Walter raised Black Angus cattle for commercial beef purposes. He raised crops to feed the cattle and for sale. Walter's farm generated losses for 19 consecutive years.

Development of the farm required a substantial investment, and Walter bore a significant risk. Walter devoted considerable time and attention to the farm. He spent all of his time on the farm, managed it jointly with his superintendent making all of the decisions pertinent to its operation, spent each morning walking or riding through his herds keeping track of the cattle, and was acutely aware of the day-to-day activities of the farm.

Walter maintained no recreational facilities such as a swimming pool or stables, and did little or no entertaining on his farm. The facilities at the farm were not extravagant or showy. Walter had always projected that the farm would generate significant income, and the farm was a trade or business, not a hobby [*Walter E. Edge, Jr.*, T.C. Memo. 1973-274].

Example 12.13 Expert Advice and Efforts to Increase Profitability

Leland E. Rosemond, a sales representative, purchased an 18-acre farm. Only two acres were tillable. He raised sheep, cattle, pigs, and chickens. Leland lived 300 miles away, but traveled to the farm frequently to do work, such as planting and harvesting hay. He and his family stayed on the farm in July and August, and he traveled there on weekends. The farm generated losses for 6 consecutive years.

Leland was constantly seeking information about farm operations from governmental bureaus, including the University of New Hampshire, the US Department of Agriculture, and the county extension agent. He sought advice about raising chickens, and made changes to his activities in accordance with the expert recommendations. He maintained a complete set of books of account, and employed an accountant to keep the records. He maintained a separate bank account with a separate checkbook for his farming operations.

The repeated losses are significant, but not controlling. Leland hoped to make the farm profitable, and the farm was operated for a profit [*Leland E. Rosemond*, PH TCM P 51205 (1951)].

Example 12.14 No Business Plan or Separate Account

Stephen Whatley, the CEO of a large bank, purchased property in rural Alabama. The previous owner had used the land as a timber farm and a cattle farm, but it was not an active operation when Stephen purchased the land.

Stephen had no business plan for the farm. He spent approximately 14 hours per week there. Stephen thinned the trees, but harvested no timber. He installed fences and conducted other activities in preparation for having cattle, but he only purchased cattle after he learned that the IRS was going to audit him.

Stephen kept minimal records for the farm and did not have a separate bank account for the farm. The farm operated at a substantial loss. Stephen enjoyed going to the farm as a retreat from his time-consuming banking business. Although many people do not find farming enjoyable, he did. He did not operate the farm for a profit [*Stephen Whatley v. Commissioner*, T.C. Memo. 2021-11].

Cross-Reference

Ranch Activity

In *Wondries v. Commissioner*, T.C. Memo. 2023-5, the court found that ranch activities were a trade or business even though they did not generate a profit. See the “Rulings and Cases” chapter in this book for a further discussion of the case.

Presumption That Activity Is for Profit

I.R.C. § 183(d) provides that an activity is presumed to be engaged in for profit if it is profitable for 3 or more years in a consecutive 5-year period (or 2 or more years in a consecutive 7-year period for activities that primarily involve breeding, showing, training, or racing horses). The benefit of the presumption begins in the third profitable year (second year for horse activities), and it applies to all subsequent years within the 5-year period (7-year period for horse activities) beginning with the first profit year.

The presumption shifts the burden to the IRS to prove that an activity is not engaged in for profit. Taxpayers without the presumption continue to bear the burden to prove that they engaged in the activity with an objective of realizing a profit.

Electing to Postpone the Determination

Under I.R.C. § 183(e), a taxpayer can elect to postpone a determination of whether the presumption applies until the end of the fourth tax year (sixth tax year for horse activities) following the first year the taxpayer engages in the activity. Taxpayers making this election file returns as though the activity is conducted for a profit.

Making the Election

The election to postpone must be filed within 3 years after the due date (without extensions) of the return for the first tax year of the activity. The taxpayer cannot make the election later than 60 days after receiving notice from the IRS proposing to disallow deductions attributable to the activity.

Taxpayers elect to postpone the determination of whether the presumption applies by filing Form 5213, Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit. When the taxpayer makes the election to postpone, the IRS will close the case to suspend until the end of the presumption period. At that time, the case will be returned to the examiner for a final determination of whether the activity is engaged in for profit.

Form 5213 extends the period of limitations for assessing any deficiency attributable to the activity during the presumption period. This period is extended 2 years after the due date for filing the return for the last tax year in the postponement period. This automatic extension applies only to a deficiency attributable to the activity and does not extend the statute of limitations for items that are not related to section 183.

Example 12.15
Hobby Determination

On April 5, 2021, Jessica Suarez began growing organic vegetables on land near her home in Oklahoma. She deducted expenses for planting and raising the crop. The expenses included an I.R.C. § 179 deduction for farm equipment. Jessica sold vegetables in 2021 and 2022, but her expenses exceeded her income in both years.

Although Jessica incurred losses in her first 2 years, she regularly attended the farmers' market in 2023, and generated a profit. Jessica believes that her activity will continue to be profitable in future years. In 2023, Jessica received a notice of deficiency proposing to disallow the deductions attributable to her farming activity in 2021 and 2022. She immediately filed Form 5213, electing to postpone the determination of whether the trade or business presumption applies to her farming activities, as shown in **Figure 12.2**.

FIGURE 12.2
Jessica Suarez's Form 5213 Electing Postponement

Form **5213** (Rev. February 2006) Department of the Treasury Internal Revenue Service	**Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit** ► To be filed by individuals, estates, trusts, partnerships, and S corporations.	OMB No. 1545-0195

Name(s) as shown on tax return	Identifying number as shown on tax return
Jessica Suarez	**XXX-XX-XXXX**

Address (number and street, apt. no., rural route) (or P.O. box number if mail is not delivered to street address)
123 Farm to Market Rd.

City, town or post office, state, and ZIP code
Norman, OK 73072

The taxpayer named above elects to postpone a determination as to whether the presumption applies that the activity described below is engaged in for profit. The determination is postponed until the close of:

- The 6th tax year, for an activity that consists mainly of breeding, training, showing, or racing horses or
- The 4th tax year for any other activity,

after the tax year in which the taxpayer first engaged in the activity.

1 Type of taxpayer engaged in the activity (check the box that applies):

☑ Individual ☐ Partnership ☐ S corporation ☐ Estate or trust

2a Description of activity for which you elect to postpone a determination

Organic vegetable farming

The IRS will suspend the case until the end of the 2025 tax year. At that time, the IRS will look at the 5-year period from 2021 through 2025 and determine whether Jessica's farming activity was engaged in for a profit. If Jessica's activity is profitable in 2023, 2024, and 2025, the trade or business presumption will apply, and the IRS will have the burden to prove that the farming activity was a hobby. The IRS will have until April 15, 2028 (2 years after the due date of the 2025 return), to assess any deficiency for Jessica's farming activity in tax years 2021 through 2025.

Hobby Loss Limitations

If an activity is not engaged in for a profit and is instead engaged in for sport, hobby, or recreation, then, in general, no business deduction attributable to that activity is allowed [I.R.C. § 183(b)]. The taxpayer can take deductions that are allowed under other code sections [Treas. Reg. § 1.183-1(b)(1)(i)]. These expenses include mortgage interest [I.R.C. § 163] and real estate taxes [I.R.C. § 164(a)].

Practitioner Note

Loss Limitations Do Not Apply to C Corporations

The section 183 hobby loss limits apply to individuals, partnerships, estates, trusts, and S corporations. Section 183 does not apply to C corporations.

Taxpayers engaged in hobby farming report their income from hobby activities on Schedule 1 (Form 1040), Additional Income and Adjustments to Income, line 8(j). Until 2018, taxpayers could deduct the expenses of carrying on hobby activities in an amount up to the gross income produced from the activity as a miscellaneous itemized deduction. This miscellaneous itemized deduction subject to the 2%-of-AGI floor is suspended through 2025.

Although taxpayers cannot deduct hobby expenses on Schedule A (Form 1040), Itemized Deductions, they are required to pay income tax on only gross income, not gross receipts. Treas. Reg. § 1.183-1(e) provides that gross income from an activity not engaged in for profit includes the total of all gains from the sale, exchange, or other disposition of property and all other gross receipts derived from such activity. Gross receipts from an activity not engaged in for a profit may be reduced by cost of goods sold (COGS) if the taxpayer consistently determines income by subtracting COGS and follows generally accepted methods of accounting in determining income.

Cross-Reference

Penalties for Noncompliance

If the IRS determines that a taxpayer has treated a hobby activity or a startup activity as a trade or business, and the taxpayer took deductions or claimed losses that were not allowed, the IRS will issue a notice of deficiency and often impose an I.R.C. § 6662 accuracy-related penalty. The penalty is 20% of any underpayment attributable to negligence or disregard of the rules [section 6662(b)(1)] or substantial understatement of tax [section 6662(b)(2)]. The penalty will not be imposed if the taxpayer had reasonable cause for the position taken and acted in good faith. See the "Penalties and Defenses" chapter in this book for a discussion of the reasonable cause and good faith defenses to the penalty.

Example 12.16
Applying the Hobby Loss Limits

Bob and Deborah Lane live on 20 acres in a suburb of New York. Bob works for a local security firm. Deborah is a data center manager. Bob and Deborah earned $255,000 in W-2 income in 2023.

After attending a seminar about developing a more self-reliant and resilient food networks, Bob and Deborah purchased ten chickens. In 2023, they bought a tractor and constructed a barn adjacent to their pasture. They sold several dozen eggs a month to colleagues at work. Bob and Deborah used the remainder of the eggs for personal use.

Bob and Deborah do not have a business plan or a separate bank account for their farming activity. They have not consulted with experts about animal production.

In 2023, Bob and Deborah want to use section 179 to expense the cost of their tractor. They also want to begin depreciating the cost of their barn and deduct the expenses of their livestock activities. However, the hobby loss factors (discussed earlier) indicate that Bob and Deborah are not operating their livestock activity as a trade or business. They have no business plan and have not consulted experts. The time they devote to the activity is limited to the time they are not engaged in demanding full-time jobs.

Bob and Deborah cannot deduct expenses of an activity that is not engaged in for profit (unless otherwise deductible under another code section). However, they may be able to subtract their production costs as cost of goods sold.

ISSUE 4: FARMING S CORPORATIONS This section discusses important issues for tax practitioners working with farm businesses taxed as S corporations.

In fiscal year 2022, there were 5,583,837 Forms 1120-S, U.S Income Tax Return for an S Corporation, filed, which exceeded the 4,582,871 Forms 1065, U.S. Return of Partnership Income, and the 2,260,757 Forms 1120, U.S. Corporation Income Tax Return, that were filed [IRS Data Book Table 2: 2022]. With more taxpayers choosing to operate their businesses as S corporations, it is important for tax practitioners to understand the use of S corporations for agricultural businesses.

This section briefly reviews the formation of an S corporation, including eligibility requirements and the S corporation election. This section then reviews the tax advantages of operating as an S corporation, including the single level of tax, self-employment tax savings, and the qualified business income (QBI) deduction. This section next discusses the tax disadvantages of operating as an S corporation, including possible gain on incorporation of a farming business with significant debt and depreciated assets and the corporate-level taxes that may apply to an S corporation with C corporation history. This section also explains the potential tax liability incurred by the estate or heirs of a deceased shareholder that sells appreciated corporate assets, and how a liquidation of the corporation in the same tax year can offset that gain.

S Corporation Formation

The Internal Revenue Code recognizes only two business entities, the partnership [I.R.C. 7701(a)(2)] and the corporation [I.R.C. § 7701(a)(3)]. There is no statutory classification for an organization that does not fit into one of these two categories. A state law corporation is, by default, a C corporation for federal tax purposes.

Subchapter S of the Internal Revenue Code was enacted in 1958 to encourage the creation of small and family-owned businesses. Eligible small business corporations can elect S corporation status by filing Form 2553, Election by a Small Business Corporation. Thus, an entity that elects to be taxed as an S corporation must meet the eligibility requirements of I.R.C. § 1361 and file the I.R.C. § 1362 election.

Practitioner Note

Check-the-Box Regulations

Under Treas. Reg. § 301.7701-3, default classification rules apply to entities that are not incorporated under state law. A single-member LLC, for example, is by default classified as a disregarded entity. A multi-member LLC is by default classified as a partnership for federal tax purposes. If otherwise qualified, these entities can make an election to be taxed as an S corporation. An unincorporated entity can typically change its tax status without changing its nontax business form. An unincorporated entity makes the election to be taxed as a C corporation on Form 8832, Entity Classification Election, or to be taxed as an S corporation on Form 2553, Election by a Small Business Corporation.

Eligible Small Business Corporation

Under I.R.C. § 1361, an S corporation is a small business corporation that makes the I.R.C. § 1362 election to be an S corporation. A small business corporation must meet the following requirements:

1. It is a domestic corporation.
2. It does not have more than 100 shareholders.
3. All its owners are US citizens or resident alien individuals, estates, certain trusts, or certain tax-exempt organizations.
4. It does not have more than one class of stock.

Domestic Corporation

A business entity, including a disregarded entity, is domestic if it is created or organized as any type of entity (e.g., corporation, unincorporated association, partnership, or LLC) under the laws of the United States or any state [Treas. Reg. § 301.7701-5(a)]. The entity is a corporation if it is organized under a federal or state statute that describes it as a corporation [Treas. Reg. § 301.7701-2(b)(1)] or if an unincorporated entity elects to be a corporation for federal income tax purposes.

Limit on Number of Shareholders

An S corporation cannot have more than 100 shareholders at any time. However, the S corporation may have more than 100 total shareholders in a tax year if there are share purchases and sales. Shareholders are generally counted separately, even if stock is owned jointly as tenants in common or in joint tenancy. However, spouses are treated as one shareholder, and a grantor trust and its grantor are treated as one shareholder. Extended family attribution rules treat all members of a family as a single shareholder for purposes of the 100-shareholder limit [I.R.C. § 1361(c)(1)]. A family includes six generations of descendants from a common ancestor, including spouses, former spouses, eligible foster children, and adopted children [I.R.C. § 1361(c)(1)(B)].

Eligible Shareholders

An S corporation can have only eligible shareholders. The following are eligible shareholders in an S corporation:

1. Individuals who are US citizens or residents
2. Decedent and bankruptcy estates
3. Certain trusts such as revocable (grantor) trusts
4. I.R.C. § 501(c)(3) tax-exempt entities
5. I.R.C. § 401(a) qualified plans

Practitioner Note

Inadvertent Termination

If an S election is inadvertently terminated because, for example, shares are transferred to an ineligible shareholder, the corporation will usually be taxed as a C corporation. There is a general prohibition against making a new S corporation election if the corporation terminated an S election within 5 years [I.R.C. § 1362(g)]. If the corporation then decides to reelect S status, it may be subject to tax at the entity level (such as the built-in gains tax) [I.R.C. § 1374]. I.R.C. § 1362(f) provides relief from certain defective elections and inadvertent terminations. Within a reasonable time after discovery of the error, the corporation must become an eligible small business corporation. The taxpayer requests defective election relief by requesting a letter ruling.

Example 12.17
IRA Shareholder

In 2018, Crops, Inc. was incorporated in Minnesota and made a valid S corporation election 2 months after its incorporation. At the time of the election, the sole shareholders were individuals, James Jensen and Lydia Gomez. In 2020, James transferred his shares to a self-directed IRA. The IRA is an ineligible shareholder, and the S election terminated on the date of the transfer.

The corporation and its shareholders did not know that an IRA was an ineligible S corporation shareholder. When James discovered the error, the IRA distributed its shares back to James. Crops, Inc. filed its tax returns consistent with being an S corporation, and James and Lydia agreed to make all adjustments required by the IRS. Crops, Inc. can request a private letter ruling (PLR) determining that the termination was inadvertent [Ltr. Rul. 202319003 (January 17, 2023)].

Cross-Reference

Trust as Eligible Shareholder

See pages 104–105 in the *2020 National Income Tax Workbook* for a discussion of trusts as eligible S corporation shareholders.

One Class of Stock

An S corporation must have a single class of stock [I.R.C. § 1361(b)(1)(D)]. This rule applies only to outstanding shares. Differences in voting rights do not create multiple classes of stock, and the corporation may have voting and nonvoting common stock.

A corporation is treated as having one class of stock if all outstanding shares confer identical rights to distributions and liquidation proceeds. The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds [Treas. Reg. § 1361-1(l)(2)].

Buy-sell agreements, shareholder agreements that restrict the transfer of stock, and redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights unless a principal purpose of the agreement is to circumvent the one class of stock requirements and the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value (FMV) of the stock. Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights.

Practitioner Note

LLC Operating Agreement

If an LLC elects to be taxed as an S corporation, the operating agreement may need to be amended to remove special income allocations and provide for equal distributions of liquidation proceeds.

An S corporation that has only one class of stock has identical governing provisions. The term *nonidentical governing provision* means a governing provision that results in the S corporation having more than one class of stock (even if the S corporation never made a non–pro rata distribution or liquidating distribution). Nonidentical governing provisions may result in the invalidity of an S corporation election or termination of the S corporation election. However, Rev. Proc. 2022-19, 2022-41 I.R.B. 282, provides procedures for correcting, without the receipt of a PLR, the validity or continuation of an S election with regard to one or more nonidentical governing provisions.

An eligible S corporation and its applicable shareholders can retroactively disregard an S election that was invalid or terminated because of nonidentical governing provisions. The corporation must not have made a disproportionate distribution to an applicable shareholder. It must have timely filed a return on Form 1120-S for each tax year of the corporation beginning with the tax year in which the first nonidentical governing provision was adopted and through the tax year immediately preceding the tax year in which the corporation made a request for corrective relief. Before the IRS discovers the nonidentical governing provision, the corporation must complete a Corporate Governing Provision Statement and a Shareholder Statement for each applicable shareholder [see Rev. Proc. 2022-19 § 3.06(2)(c) for the contents of the statements, and Appendices A and B for sample statements].

Example 12.18
Multiple Classes of Stock

Roundup Farms, LLC was created in 2020, and elected to be an S corporation effective that tax year. Roundup's operating agreement required the company to make liquidating distributions in accordance with each member's capital account balance. Consequently, Roundup's S corporation election terminated on the effective date of its operating agreement.

Roundup filed its 2020 and 2021 Forms 1120-S consistent with its election as an S corporation. It made no disproportionate distributions. Roundup discovered the error in 2022, before the IRS discovered the provision in its operating agreement. It immediately amended and restated its operating agreement to remove the terms causing it to have more than one class of stock and took the corrective relief measures under Rev. Proc. 2022-19.

Cross-Reference

Correcting Eligibility Errors

Rev. Proc. 2022-19 provides procedures that allow S corporations and their shareholders to resolve several frequently encountered eligibility issues, without requesting a PLR. This revenue procedure provides relief from inadvertent invalid elections or terminations. See the "Business Entity Tax Issues" chapter in this book for a discussion of Rev. Proc. 2022-19.

S Corporation Election

A company electing S corporation status must file Form 2553, Election by a Small Business Corporation, with the IRS Service Center (Kansas City or Ogden) where the company files (or will file) its tax returns. If an unincorporated entity is electing S corporation status as of the first day it is seeking entity classification as a corporation, the entity can file only Form 2553 and does not have to also file Form 8832. Each shareholder who owns shares at the time of filing the S corporation election must consent to the election. The corporation can file Form 2553 by mail or by fax. Form 2553 is due by the fifteenth day of the third month of the tax year for which the election is to take effect. There is a simplified method for taxpayers to request relief for late S elections [Rev. Proc. 2013-30, 2013-36 I.R.B. 173].

S Corporation—Tax Advantages

Agricultural businesses may choose to operate as S corporations because there is typically a single level of tax at the owner level, as opposed to a C corporation in which income is taxed at the corporate level, and the distribution of earnings and profits is taxed again as income to the shareholder. The S corporation must pay its shareholders reasonable compensation for services provided to the corporation, and that compensation is subject to employment taxes and included in W-2 wages for the qualified business income (QBI) deduction. However, other distributions are not subject to self-employment (SE) tax and may qualify as QBI. Also, the distributive share of income of materially participating S corporation shareholders is not subject to the net investment income tax (NIIT). This section discusses the single level of tax, the QBI deduction, and the SE tax treatment of S corporation distributions.

Single Level of Tax

Like a partnership, an S corporation (with no C corporation history) is not subject to federal income tax on its earnings [I.R.C. § 1363(a)]. Instead, items of income, loss, deduction, and credits pass through to the shareholders, who report their pro rata share of these items on their individual income tax returns [I.R.C. § 1366(a)].

Cross-Reference

Entity-Level Tax

An S corporation with C corporation history may be subject to tax at the entity level. Thus, an S corporation that was formerly a C corporation may be taxed on its built-in gains (BIG) under I.R.C. § 1374. It may also be taxed on its excess net passive income under I.R.C. § 1375. See pages 141–148 in the *2020 National Income Tax Workbook* for a discussion of the BIG tax and the tax on excess net passive income.

In 2023, C corporation income is generally taxed at a flat 21% rate. Most distributions to shareholders are qualified dividends, taxed at a maximum rate of 20% (23.8%, if the NIIT applies). Thus, the combined maximum rate is 41% (44.8% if the NIIT applies). By contrast, S corporation distributions and wages are taxed to the shareholders at a maximum 37% rate.

Cross-Reference

C Corporations vs. Pass-Through Entities

Because of the lower tax rate on corporate income, C corporations that retain earnings may pay less taxes than a partner in a partnership or an S corporation shareholder. However, if the C corporation makes distributions, the combined corporate level tax and tax on shareholder distributions is usually higher than the tax on a partnership or S corporation owner. See pages 458–480 in the *2018 National Income Tax Workbook* for a comparison of C corporation taxation with the taxation of a disregarded entity, partnership, and S corporation.

Self-Employment Tax Savings

A partnership (including a multimember LLC taxed as a partnership) passes through its items of income, gain, losses, deductions, and credits to its partners. The partners are taxed on their distributive share of partnership income. A partner (other than a limited partner) must also pay SE tax on his or her distributive share of partnership income. By contrast, an S corporation must pay its shareholders reasonable compensation for their services to the corporation. That compensation is subject to employment taxes. However, other distributions are not subject to SE tax.

Wages and Self-Employment Income

Wages and self-employment earnings are subject to employment taxes under the Federal Insurance Contributions Act (FICA) and the Self-Employment Contributions Act (SECA), respectively. FICA imposes a 12.4% social security tax on wages up to $160,200 (in 2023) and a 2.9% Medicare tax on all wages. Employers pay one-half of the FICA tax, and the employee pays one-half. The employer can deduct its one-half share of FICA taxes.

A self-employed taxpayer pays the 12.4% social security tax (up to $160,200 of earnings for 2023) and the 2.9% Medicare tax on 92.35% of self-employment earnings, which equalizes the self-employed taxpayer with an employee for whom the employer pays a 7.65% share of FICA tax that is not included in the employee's income. The self-employed taxpayer (like an employer) can deduct one-half of SE tax. The taxpayer calculates the deduction on Schedule SE (Form 1040), Self-Employment Tax, and reports the deduction on Schedule 1 (Form 1040), Additional Income and Adjustments to Income, line 14.

Cross-Reference

Estimated Tax Payments

Self-employed taxpayers must generally make estimated tax payments or pay a penalty. For more information on estimated tax liability and planning for farmers, see pages 586–589 in the *2019 National Income Tax Workbook*.

S Corporation Distributions

S corporation shareholders who perform services for the corporation are subject to FICA tax on their wages. S corporation undistributed taxable income that must be included in each shareholder's gross income does not constitute net earnings from self-employment [Rev. Rul. 59-221, 1959-1 C.B. 225]. However, distributions paid to shareholders will be recharacterized as wages when such distributions are paid in lieu of reasonable compensation for services performed for the S corporation [Rev. Rul. 74-44, 1974-1 C.B. 287] (discussed later).

A disregarded entity or partner in a partnership pays SE tax on all the business income, and typically is subject to more SE tax than the S corporation. For instance, a taxpayer with $10,000 of SE income and whose wages plus net SE earnings do not exceed the maximum wage limit for social security tax ($160,200 for 2023) is subject to $1,413 ($10,000 × 0.9235 × 0.153) SE tax on this income. The one-half of SE tax deduction reduces the taxpayer's taxable income by $707 ($1,413 × 0.50). A taxpayer with a 22% marginal tax rate pays approximately 34.6% [{$1,413 SE tax – ($707 × 0.22 marginal tax rate) + ($10,000 × 0.22 marginal tax rate)} ÷ $10,000] total tax on this income.

Cross-Reference

Limited Partners

A limited partner is generally not subject to SE tax on his or her distributive share of partnership income. See pages 141–142 in the *2021 National Income Tax Workbook* for a discussion of the proposed regulations that describe when an LLC member may be treated as a limited partner.

Reasonable Compensation

Both S and C corporations deduct expenses for wages paid, even if those payments are made to shareholder-employees. Because wages are deductible, but dividends paid are not, there is an incentive for a C corporation to disguise distributions to owners as wages to claim a deduction. On the contrary, S corporation wages are subject to employment taxes, which creates an incentive to characterize payments as a share of corporate earnings instead of wages.

If compensation paid to a C corporation shareholder is unreasonably high, it is not deductible to the corporation and it is taxed to the shareholder as a dividend. To prevent the treatment of wages as earnings that are not subject to employment taxes, an S corporation must pay its shareholders reasonable compensation for services that they provide to the corporation. If the salary paid to an S corporation shareholder is not reasonable, the IRS can recharacterize a shareholder distribution as wages that are subject to employment taxes.

C Corporation Shareholder

Courts have found that the following factors may be used to determine the reasonableness of compensation paid to a C corporation shareholder:

1. The employee's qualifications
2. The nature, extent, and scope of the employee's work
3. The size and complexities of the business
4. A comparison of salaries paid with the gross income and the net income

5. The prevailing general economic conditions
6. Comparison of salaries with distributions to stockholders
7. The prevailing rates of compensation for comparable positions in comparable concerns
8. The salary policy of the taxpayer as to all employees
9. For small corporations with a limited number of officers, the amount of compensation paid to the particular employee in previous years

[*Charles Schneider & Co. v. Commissioner*, 500 F.2d 148 (8th Cir. 1974), citing *Mayson Mfg. Co. v. Commissioner*, 178 F.2d 115 (6th Cir. 1949)]

S Corporation Shareholder

Reasonable compensation paid to an S corporation shareholder is determined by facts and circumstances, and the burden of proof is on the taxpayer to substantiate that the compensation is reasonable. The reasonable compensation factors are generally the same as the factors for a C corporation shareholder, but in contrast to considering whether a C corporation is overpaying compensation to increase a corporate income tax deduction, the analysis determines whether an S corporation is underpaying shareholder compensation to decrease FICA tax liability. Courts will look at the economic substance of the transaction, rather than the form of payment chosen by the corporation, to determine whether distributions to a shareholder are actually remuneration for services and must be recharacterized as wages.

Cross-Reference

Reasonable Compensation Determination

The IRS Reasonable Compensation Job Aid for IRS Valuation Professionals (October 29, 2014) describes three valuation methods for IRS agents and field personnel to determine reasonable compensation: a market approach, an income approach, and a cost approach. See pages 135–137 in the *2020 National Income Tax Workbook* for a further explanation of how to determine reasonable compensation for an S corporation shareholder.

When establishing compensation for an agricultural S corporation shareholder, the company must consider the judicial factors and document the basis for the wages paid. The market approach compares the shareholder-employee's compensation with typical compensation in the industry. It asks how much compensation would be paid for the same position, held by a nonowner in an arms-length employment relationship, at a similar company.

Sources of information include state and federal labor statistics, such as the National Occupational Employment and Wage Estimates compiled by the US Bureau of Labor Statistics [www.bls.gov/oes/current/oes_nat.htm]. In May 2022, for example, the annual median wage for farmers, ranchers, and other agricultural managers was $83,790. The average for an agricultural manager in Iowa was $99,510, and the average in North Dakota was $101,280. An S corporation that is trying to establish reasonable compensation for its shareholder-employees may consider hiring a consulting firm to conduct a compensation study.

Practitioner Note

Retirement Income Impact

Characterization of S corporation shareholder compensation as a distribution rather than wages may reduce future social security income. It may also limit contributions to a retirement plan because contributions to a retirement plan can only be made from compensation. For a self-employed individual, compensation is earned income. Distributions to an S corporation shareholder do not constitute earned income for retirement plan purposes [I.R.C. §§ 401(c)(1), 1402(a)(2)].

QBI Deduction

C corporation income is not eligible for the QBI deduction. Through 2025, distributions to S corporation shareholder-employees are eligible for the 20% I.R.C. § 199A QBI deduction. The QBI deduction applies to qualified business income. For purposes of the QBI deduction, reasonable compensation of an S corporation shareholder includes any amounts (including distributions) paid by the S corporation to the shareholder, up to the amount that would constitute reasonable compensation.

Wages reduce qualified business income, which may reduce the QBI deduction. However, for taxpayers who are above the QBI threshold, the deduction may be limited if the corporation does not pay enough W-2 wages. Thus, if an S corporation shareholder's taxable income is above the QBI threshold ($182,100 for single and $364,200 for MFJ for 2023), higher W-2 wages may increase QBI eligibility.

S Corporation—Tax Disadvantages

Although many S corporation owners will pay less SE tax than owners of comparable businesses taxed as partnerships or disregarded entities, tax practitioners must consider the tax disadvantages of operating a farm business as an S corporation. Except as otherwise provided in subchapter S, the subchapter C tax rules apply to an S corporation and its shareholders [I.R.C. § 1371(a)].

For a farming business with significant debt and depreciated assets, there may be gain on incorporation or upon electing S corporation status. Typically, there is gain on the distribution of appreciated S corporation assets, which limits the shareholders' ability to divide the business or change the tax structure from an S corporation to a partnership or sole proprietorship.

For tax years 2018 through 2025, eligible taxpayers can claim a qualified business income (QBI) deduction of up to 20% of qualified business income. C corporations are not eligible for the deduction. A farming C corporation may want to convert to an S corporation to take advantage of the deduction and avoid the C corporation double taxation (at the corporate level and on dividends). However, an S corporation that was formerly a C corporation may be taxed on its built-in gains under I.R.C. § 1374. The S corporation may also be taxed on its excess net passive income under I.R.C. § 1375.

Unlike a partnership that may receive a step up in basis on the partner's share of partnership assets when a partner dies, an S corporation shareholder receives only an adjustment to the basis of his or her shares and not an adjustment to the S corporation assets. If the estate or heirs of a deceased shareholder sell appreciated assets, they may incur significant tax liability. This section discusses the gain on the sale, and how a liquidation of the corporation in the same tax year can offset that gain.

Gain on Incorporation or Conversion

Under I.R.C. § 351, no gain or loss is recognized when property is transferred to the corporation solely in exchange for stock in the corporation and immediately after the exchange such persons are in control (at least 80% of voting and shares) of the corporation. However, a shareholder recognizes gain if assumed liabilities exceed the adjusted basis of the contributed assets.

Nonrecognition

A partnership that elects to be classified as a corporation is treated as contributing all assets and liabilities to the corporation in exchange for stock, and immediately thereafter, the partnership liquidates by distributing the stock of the corporation to its partners [Treas. Reg. § 301.7701-3(g)(1)(i)]. The liquidating distribution of stock to the partners is typically tax-free. However, the distribution may create a tax liability in the following circumstances:

1. In the prior 7 years, the partnership received property with precontribution gain [I.R.C. §§ 704(c) and 737].
2. A partner receives a disproportionate share of I.R.C. § 751 assets (unrealized receivables and substantially appreciated inventory).
3. The distribution is deemed part of a disguised sale [I.R.C. § 707].

Similarly, when a disregarded entity elects to be classified as a corporation, the owner of the eligible entity is treated as contributing all assets and liabilities of the entity to the association in exchange for stock of the corporation [Treas. Reg § 301.7701-3(g)(1)(iv)].

Cross-Reference

Section 751 Assets

See the “Business Entity Tax Issues” chapter in this book for a discussion of section 751 assets.

Practitioner Note

Control Test

The 80% control test must be applied when an S corporation (or an entity that has elected to be taxed as an S corporation) issues new shares in exchange for the contribution of appreciated property. The transaction is taxed as a sale of the property unless the new shareholders have 80% or more control of the corporation immediately after the transfer. The 80% control test for nonrecognition treatment also applies to subsequent contributions of appreciated property by existing shareholders.

Assumed Liabilities

The deemed contribution of partnership assets and liabilities in exchange for stock is tax-free if the debt transferred to the corporation is less than the adjusted basis of the contributed assets and the contributing taxpayers control 80% or more of the stock immediately after the contribution. If the liabilities assumed exceed the adjusted basis of the transferred assets, the owners must recognize gain to the extent the debt assumption exceeds the adjusted basis [I.R.C. § 357(c)(1)].

In *Seggerman Farms v. Commissioner*, 308 F.3d 803 (7th Cir. 2002), the taxpayers were grain and cattle farmers in Illinois. They incorporated their farming business by transferring assets and liabilities to the corporation in exchange for shares in the corporation. The liabilities transferred to the corporation exceeded the transferors’ adjusted basis in the transferred assets. The Seggermans remained liable as guarantors of the debt. The IRS assessed tax on the amount by which the liabilities exceeded the adjusted basis.

The taxpayers argued that, as guarantors of the corporation’s debt, they were not relieved personally from any debt that the corporation assumed, and therefore they should not have to recognize any gain on the amount of the liabilities that exceeds the adjusted basis of the transferred assets. The court noted that personal guaranties of corporate debt are not the same as incurring indebtedness to the corporation because a guaranty is merely a promise to pay in the future if certain events should occur. The guaranties do not constitute economic outlays. The court concluded that the plain language of section 357(c) requires that the amount by which transferred liabilities exceed the taxpayer's basis in the transferred assets be recognized as taxable gain.

Practitioner Note

Promissory Note

The Seggermans relied on *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1998), and *Lessinger v. Commissioner*, 872 F.2d 519 (2nd Cir. 1989), in which taxpayers were permitted to avoid section 357(c)(1) gain recognition despite liabilities transferred in excess of assets. In Lessinger, a loan receivable owed by the taxpayer equal in amount to the excess of liabilities transferred over assets was recorded on the corporate books of the transferee corporation. The court held that the loan receivable represented a genuine debt, and thus the taxpayer realized no gain on the transfer under section 357 because liabilities transferred equaled assets transferred. In Peracchi, a taxpayer transferred encumbered real property to his corporation, and liabilities transferred exceeded his adjusted bases in the transferred property. The taxpayer also contributed a note to the corporation. The court held that the taxpayer's basis in the note represented genuine indebtedness and that, therefore, the aggregated basis of transferred property exceeded transferred liabilities. Therefore, no taxable gain was recognized on the transfer.

Cross-Reference

S Corporation Basis and Debt

For purposes of applying the loss limitation rules (loss deductions limited to basis), partners in a partnership generally can include their allocable share of partnership debts in their basis. An S corporation shareholder obtains debt basis by loaning the S corporation money or property in which the shareholder has basis. There must be bona fide indebtedness from the corporation to the shareholder [Treas. Reg. § 1.1366-2]. A shareholder does not obtain basis in indebtedness of the S corporation merely by guaranteeing a loan or acting as a surety, accommodation party, or in a similar capacity relating to a loan. See the "Business Entity Tax Issues" chapter in this book for a discussion of reporting S corporation shareholder basis and debt basis.

Example 12.19
Assumed Debt Exceeds Adjusted Basis

In 2018, Alex Heinzig formed Hogs West, LLC to operate his swine finishing operation. The LLC owned three hog buildings and farm equipment. It did not own land or other assets. After the section 179 deduction and depreciation, the adjusted basis of the LLC assets is $105,000 and their FMV is $910,000. The property is encumbered by a $425,000 loan. **Figure 12.3** shows the LLC's assets and liabilities.

FIGURE 12.3
Hogs West, LLC's Assets and Liabilities

Asset Description	Adjusted Basis	FMV	Liability
Hog building one	$100,000	$300,000	$200,000
Hog building two	0	250,000	100,000
Hog building three	0	200,000	75,000
Equipment	5,000	150,000	50,000
Miscellaneous tools	0	10,000	0
Total	$105,000	$910,000	$425,000

In 2023, Alex asked his tax adviser if the LLC could elect to be taxed as an S corporation to reduce Alex's SE tax liability. The tax adviser explained to Alex that electing S corporation status for the LLC would cause him to recognize $320,000 ($425,000 assumed liability – $105,000 adjusted basis in transferred assets) gain, taxed as ordinary income. After the transfer, Alex's basis in his S corporation shares would be zero [$105,000 (adjusted basis) – $425,000 (debt assumed by corporation) + $320,000 (gain recognized)]. The corporation's basis in the property would be increased to $425,000 to account for Alex's recognized gain.

Practitioner Note

Assumption of Debt

Generally, a recourse liability is treated as having been assumed by the corporation if, based on all the facts and circumstances, the corporation has agreed to, and is expected to, satisfy the liability. The assumption of the liability is based entirely on an arrangement between the shareholder and the S corporation, and not on any arrangement with the lender. Generally, absent an agreement otherwise, a nonrecourse liability is treated as having been assumed by the transferee of any asset subject to the liability.

Distribution of Appreciated Property

With a few limited exceptions, no gain is recognized when a partnership distributes appreciated property to a partner. When an S corporation with no C corporation history distributes appreciated property, the corporation must recognize, and pass through to its shareholders, gain as if the property was sold to the shareholders at its FMV [I.R.C. § 311(b)]. The gain recognized by the S corporation is passed through to the shareholders on a pro rata basis, and increases their basis in the stock. This rule also applies to liquidating distributions [I.R.C. § 336(a)].

If the S corporation distributes property with a FMV that is less than its adjusted basis, the loss is disallowed, except upon a complete liquidation. The loss amount is treated as a nondeductible expense allocated to all the shareholders according to their stock ownership percentages. The shareholder's basis in the distributed property is its FMV [I.R.C. § 301(d)].

Example 12.20
Distribution to Shareholders

Gerry Jurgens and Bruce Talbot are the sole shareholders in J&T Farming, Inc., an S corporation. The corporation was never a C corporation and has no C corporation history. J&T Farming owns equipment, but no farmland. In 2023, Gerry and Bruce decided that they wanted to each conduct the farm business separately. **Figure 12.4** shows J&T Farming's assets. J&T Farming distributes the equipment to Gerry and distributes $335,000 cash to Bruce.

FIGURE 12.4
J&T Farming's Assets

Asset Description	Adjusted Basis	FMV
Tractor	$ 0	$ 75,000
Planter	0	35,000
Combine	20,000	225,000
Total	$20,000	$335,000

J&T Farming will recognize $315,000 ($335,000 FMV – $20,000 adjusted basis) gain on the transfers. This gain is passed through to Gerry and Bruce and is subject to ordinary income tax as section 1245 depreciation recapture. Gerry is treated as having received a $335,000 cash distribution, and his basis in the equipment is $335,000.

Cross-Reference

Divisive Reorganizations

A farming corporation may have several reasons to want to separate businesses. The shareholders may be involved in different lines of the same business, or the same business in different geographic areas. A division may be necessary to resolve disputes over corporate management, or the shareholders may wish to separate liability for certain business operations or a separation may facilitate borrowing. In divisive reorganizations, one corporation is divided into two or more corporations. In general, if a corporation meets the requirements for a divisive reorganization, there is no recognition of gain or loss on the transaction. See pages 105–113 in the *2022 National Income Tax Workbook* for a discussion of a split-off.

Built-In Gains Tax

S corporations that used to be C corporations may have a corporate-level tax on gains recognized on the sale of assets. This tax may reduce, or even negate, the benefits of the S election. During a 5-year recognition period, beginning with the first day of the first tax year for which the corporation was an S corporation, there is a built-in gains (BIG) tax on any net built-in gain recognized by the corporation [I.R.C. § 1374(d)(5)].

The BIG tax is assessed on assets sold by an S corporation that were acquired while the entity was taxed as a C corporation. The appreciation on those assets at the time the S election was made is taxed at the highest corporate tax rate, which is currently 21%. The BIG tax is in addition to the tax on the gain passed through to the shareholders on the sale of the corporation's assets by the corporation.

Cross-Reference

Built-In Gains Tax

The BIG tax applies only to assets that have appreciated in value in a C corporation. Thus, if the corporation has always been an S corporation, or has been an S corporation for at least 5 years after it converted from a C corporation or acquired assets from a C corporation in certain reorganizations, the BIG tax does not apply. See pages 142–146 in the *2020 National Income Tax Workbook* for a detailed discussion and examples of calculating the BIG tax.

Net Passive Investment Income

Although S corporations are pass-through entities, an S corporation that has accumulated earnings and profits (AE&P) from C corporation years may be subject to an entity level tax on excess net passive income. If an S corporation has AE&P at the end of the year, and the corporation's passive investment income for the tax year exceeds 25% of gross receipts for the year, there is a corporate-level tax on the excess net passive income. If the corporation exceeds the 25% limit for 3 consecutive tax years, the corporation's S status will terminate on the first day of the next tax year [I.R.C. § 1362(d)(3)].

Calculating the Tax

The tax is calculated by multiplying the excess net passive investment income by the highest corporate income tax rate, which is currently 21%. Excess net passive income is the percent of net passive income equal to passive investment income for the tax year that exceeds 25% of the gross receipts for the tax year divided by the passive investment income for the tax year. It is limited to the corporation's taxable income, calculated as if the corporation was a C corporation.

Gross receipts are defined as the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income. Passive investment income includes gross receipts from the following:

- Royalties
- Rents
- Dividends
- Interest (except interest on the sale of a capital asset in the course of the corporation's ordinary trade or business)
- Annuities

Net passive income is generally passive investment income reduced by any allowable deduction directly connected with the production of the income (except NOL deductions and corporate deductions allowed under I.R.C. §§ 241–247 and 249–250).

Avoiding the Tax

If, for example, a farm C corporation elects S corporation status, and the corporation has cash rent from the lease of farmland, the corporation may need to structure the lease to avoid the tax on net passive investment income and termination of its S corporation status. The corporation can provide significant services under the lease. Rents received by a corporation are derived in an active trade or business of renting property and are not passive income if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases.

Another strategy to avoid net passive investment income is to pay out all AE&P to shareholders in the form of a dividend. Once there is no more AE&P, the passive investment income rules no longer apply. If the S corporation does not have sufficient cash to pay out AE&P, the corporation can make a deemed earnings and profits distribution [Treas. Reg. § 1.1368-1(f)(3)]. To elect a deemed AE&P distribution, the corporation must obtain permission from all the shareholders. The shareholders will be subject to tax on the deemed distribution, even though no cash is received and are deemed to have contributed the distribution to the corporation.

The corporation can also engage someone to custom farm the ground or lease the land under a crop share arrangement.

Example 12.21
Crop Share Rental Arrangement

Land Co. operated as a C corporation for several years, and then made an S corporation election. It has AE&P from when it was a C corporation. Land Co. owns 405 acres of farmland that are leased to a tenant under a crop share arrangement. Under the arrangement, Land Co. pays 40% of crop-related expenses in return for 40% of the gross crop proceeds. The tenant is responsible for 60% of the expenses and receives 60% of the crop proceeds. Land Co.'s secretary-treasurer makes day-to-day management decisions for the farm. He advises and consults with the tenant regarding planting, harvesting, and marketing. The secretary-treasurer visits the farm at least twice each month, with more frequent visits during planting and harvesting seasons.

The income received by Land Co. pursuant to this arrangement is not rent. The term rent does not include income realized by a landowner under a share-farming arrangement where the landowner participates to a material degree in the production of farm commodities through physical work or management decisions, or a combination of both [Ltr. Rul. 8927039 (April 11, 1989); Rev. Rul. 61-112, 1961-1 C.B. 399 (interpreting former I.R.C. § 1372)].

Inherited S Corporation Assets

When a partner dies, the basis of the deceased partner's interest in the partnership (outside basis) is adjusted to FMV on the date of death (or alternate valuation date). Additionally, if a partnership has an I.R.C. § 754 election in place, the inside basis of the partnership property attributable to the deceased partner is increased to FMV under I.R.C. § 743(b). This allows flexibility for the heirs and successors of the deceased partner.

No similar provision exists for S corporations. Although the value of the deceased shareholder's stock is adjusted to its FMV at the death of the shareholder, the basis of the underlying assets is not adjusted. A distribution or sale of appreciated assets of an S corporation will result in gain, even after the death of a shareholder. Additionally, with no basis adjustment, there are no larger depreciation deductions for depreciable assets after the death of a shareholder.

To avoid significant tax on the sale of the S corporation assets, the estate can sell the assets and liquidate the corporation in the same year. The gain on the sale of the assets increases the basis of the shares. When the S corporation liquidates, the corporation is treated as having sold all its assets for their FMV. The estate is treated as having sold its S corporation shares for an amount equal to the FMV of the assets it receives in the liquidating distribution from the S corporation. The deemed sale of the shares creates a long-term capital loss that offsets the gain passed through from the sale of the appreciated assets. This capital loss will not offset depreciation recapture or ordinary income because a capital loss does not offset ordinary gain in excess of $3,000 per year.

Example 12.22
Death of a Shareholder

Huckleberry Farms, Inc. is taxed as an S corporation. August Taylor is the sole shareholder. The S corporation owns machinery with a zero adjusted basis and a $200,000 FMV. It also owns farmland with a $100,000 adjusted basis and a $1,000,000 FMV.

August died on August 8, 2023. His heirs did not want to continue the business. On the date of August's death, the value of his shares was adjusted to their $1,200,000 ($200,000 + $1,000,000) FMV. In January 2024, August's estate sells the farmland and machinery and liquidates the S corporation in the same year. **Figure 12.5** shows the calculation of gain on the sale of the assets.

FIGURE 12.5
Huckleberry Farms, Inc.'s Gain on Sale of Assets

Assets	FMV	Adjusted Basis	Gain	Character of Gain
Machinery	$ 200,000	$ 0	$200,000	I.R.C. § 1245
Farmland	1,000,000	100,000	900,000	I.R.C. § 1231
Total	$1,200,000	$100,000	$1,100,000	

The corporation recognizes and passes through to the estate $200,000 gain from the sale of the machinery and $900,000 gain from the sale of farmland. The gain increases the basis of the corporate shares to $2,300,000 ($1,200,000 + $200,000 + $900,000). When the corporate shares are liquidated, there is a $1,100,000 ($2,300,000 – $1,200,000) long-term capital loss. The $1,100,000 capital loss offsets the $900,000 long-term capital gain from the sale of the farmland. The $200,000 gain from the sale of machinery is recaptured section 1245 ordinary income. The capital loss reduces this ordinary income by $3,000.

If instead the estate sells the assets in 2023 and liquidates in 2024, it will have taxable gain in 2023 and a capital loss in 2024. The loss will not offset the gain.

ISSUE 5: TIMBER TAXATION This section discusses tax issues for forest landowners.

Because of the long-term nature of growing trees for forest products, special tax rules apply to owners of timber. This section discusses timber property basis, the tax treatment of expenses for the management of timber, and the tax consequences of timber sales. This section also explains when a taxpayer can claim a casualty loss for timber destroyed by hurricane, fire, or other casualty event.

Basis Accounts

The cost of acquiring timber is capitalized and recovered when the taxpayer sells the timber or takes depletion allowances when the taxpayer cuts the timber. Thus, taxpayers who acquire timber must determine initial basis, and set up and maintain subaccounts to track basis adjustments. Basis is used to calculate depletion at the time of a sale and to determine gain or loss on other dispositions such as involuntary conversions, casualty losses, theft, or exchange.

Initial Basis

Timber property's initial basis depends on how the property was acquired. If the property was acquired by purchase, the initial basis is the purchase price [I.R.C. § 1012]. The basis in property acquired by gift will generally equal the donor's basis [I.R.C. § 1015]. The basis of inherited property is usually the fair market value (FMV) on the date of the decedent's death, or on the alternate valuation date [I.R.C. § 1014)].

CROSS-REFERENCE

Special Use Valuation

Pursuant to I.R.C. § 2032A, an executor of an estate may be able to elect to apply a discounted value for purposes of valuing the decedent's family farm and calculating estate tax. In general, the executor can elect to value certain farm and closely held business real property at its farm or business use value rather than its FMV. If the executor elected section 2032A, special use valuation, the basis of the property is the elected special use value. See pages 249–252 in the *2020 National Income Tax Workbook* for a discussion of special use valuation.

Separate Accounts

Once the taxpayer determines the timber property's initial basis, the taxpayer must maintain separate basis accounts for each category of capital assets. Typically, the taxpayer will have accounts for land, depreciable land improvements, and timber. The taxpayer may need to maintain additional accounts for equipment and other depreciable property. If the purchase contract does not list separate prices or values for the land, timber, and other assets, the taxpayer must allocate the initial basis among the assets in proportion to the separate FMV of each on the acquisition date.

PRACTITIONER NOTE

Form T (Timber)

When setting up timber basis accounts, the taxpayer can use Form T (Timber), Forest Activities Schedule, as a guide. Form T tracks the basis that is available for depletion. Taxpayers must complete and file Form T if they claim a deduction for timber depletion, make an outright sale of timber under I.R.C. § 631(b), or elect under I.R.C. § 631(a) to treat the cutting of timber as a sale or exchange.

Land and Nondepreciable Land Improvements

Expenses associated with the land and other nondepreciable land improvements are maintained in the land account. The basis in this account is recovered when the land is sold or otherwise disposed of. Examples of nondepreciable land improvements include roadbeds (with an indefinite useful life), land impoundments, and land clearing.

Depreciable Land Improvements

Land improvements such as bridges, culverts, temporary roads, and nonpermanent fences can be depreciated. Each improvement will have a separate depreciation schedule.

Timber Accounts

Most forested property consists of different age classes, species, and quality of trees. The taxpayer typically maintains multiple subaccounts that represent the diversity of timber and its location. Subaccounts allow for a more accurate recovery of basis through depletion at the time of sale.

Subaccounts may be by products (e.g., pine pulpwood, sawtimber), species (e.g., pine, hardwood), or by stand. The timber account should include separate subaccounts for merchantable timber, young growth (premerchantable timber), and each plantation year (planted or seeded trees).

Each timber subaccount should include a dollar value (cost basis) and the timber quantity. For merchantable timber, the quantity is generally shown in tons, cords, or thousand board feet (MBF). For premerchantable timber, the quantity shown is acres.

The plantation and young growth subaccounts must reflect the establishment costs of planting or seeding timber stands [Rev. Rul. 75-467, 1975-2 C.B. 93]. Establishment costs include funds spent to prepare a site for tree planting or seeding and the cost of the seedlings or seeds. Site preparation costs include costs incurred for brush and weed control, stump removal, and leveling and conditioning the land to improve growing conditions and to facilitate planting or seeding.

Other related costs that are capitalized include the equipment depreciation attributable to site preparation and planting or seeding and the associated cost of hired labor. Hired labor includes family members who are paid for their services but does not include the value of the taxpayer's own labor.

Some expenditures made after seeding or planting, such as for brush and weed control, are also considered establishment costs because the stand is not considered established until enough stems are capable of surviving for the site to be considered adequately stocked [Rev. Rul. 76-290, 1976-2 C.B. 188]. However, the taxpayer can elect to deduct and amortize reforestation expenses (discussed later).

Example 12.23
Cost Basis Allocation

In 2023, Sandy Pinellas purchased 100 acres of timberland. The contract price was $200,000. Sandy also paid $2,000 for a survey of the property boundaries, $3,000 in legal fees, and $1,500 to a forester for a timber cruise (inventory). The total acquisition cost was $206,500 ($200,000 + $2,000 + $3,000 + $1,500).

The timber cruise valued the 20 acres of young growth timber at $500 per acre. The remaining 80 acres of merchantable timber included 3,700 tons of pine pulpwood, chip-n-saw, and sawtimber with a blended price of $17 per ton. Local prices for land of similar quality, quantity, and access indicate a land value of $1,500 per acre.

The total acquisition cost is allocated to the young growth, merchantable timber, and land account by determining the proportion of the FMV represented by each asset, as shown in **Figure 12.6**.

FIGURE 12.6
Cost Basis Allocation

Asset Account	Volume × FMV per Unit	FMV	Proportion of FMV	Allocation of Original Cost Basis
Land	100 acres × $1,500	$150,000	67.29%	$138,954
Young growth timber	20 acres × $500	10,000	4.49%	9,272
Merchantable timber	3,700 tons × $17	62,900	28.22%	58,274
Total		$222,900	100.00%	$206,500

PRACTITIONER NOTE

Remeasurement of Timber Volume

The taxpayer does not have to update the quantity in the timber basis account each year. If the taxpayer obtains a cruise, that information can be used to update the quantity in the basis account to show timber growth or natural loss. When the premerchantable timber or plantation becomes merchantable, the quantity should be updated to reflect a timber quantity. Timber quantity may be established by a cruise or a forester's estimation.

Reconstructing Basis

A forest landowner may allocate basis after the acquisition date. Treas. Reg. § 1.611-3(f) allows a retroactive basis allocation. The value must be determined using the most reliable and accurate information available with reference to the condition of the property as it existed at the acquisition date, regardless of all subsequent changes, such as changes in surrounding circumstances, and methods of exploitation, or in degree of use.

If there is no inventory from the time of acquisition, a forester can determine the standing timber that was present at the time of acquisition by using data from the current timber and estimates of the rate of growth. The forester will combine the estimates of timber at the time of acquisition with data on prices at that time to provide the timber's FMV.

Forest Management Expenses

A forest landowner incurs expenses, including operating expenses and carrying charges. These expenses may be recoverable in the year they are incurred. This section discusses operating expenses, investment expenses, and special rules that apply to fertilizer costs and reforestation expenses.

Operating Expenses

Timber property owners commonly incur costs for the day-to-day management of their property. Operating expenditures may include the following:

- Fees paid to consulting foresters
- Travel expenses directly related to the income potential of the property
- Costs of silvicultural activities such as prescribed burning and precommercial thinning
- Costs of fire, insect, and disease protection
- Cost of tools that have a short useful life
- Cost of hired labor
- Costs of road and firebreak maintenance

Timber property owners also generally incur carrying charges such as property taxes, interest, and insurance. Operating costs and carrying charges that are ordinary and necessary expenses of managing, maintaining, and conserving forest land may be deducted in the year incurred. The I.R.C. § 469 passive activity loss rules apply. The timber growing activity must be engaged in for profit, and the expenditures must be directly related to the production of income.

PRACTITIONER NOTE

Election to Capitalize Carrying Charges

A taxpayer with unimproved and unproductive property may elect to add timber-related carrying charges to the timber's basis and recover these expenses when the timber is cut or sold [Treas. Reg. § 1.266-1(b)(1)(i)]. Forestland is unproductive in any year it produces no income from its use, such as from hunting leases or timber sales. The section 266 election is made annually. The taxpayer must file a statement with his or her original tax return indicating the expenses that the taxpayer elects to capitalize.

PRACTITIONER NOTE

Uniform Capitalization

I.R.C. § 263A generally provides that the direct and indirect costs properly allocable to real or tangible personal property produced by the taxpayer must be capitalized. Section 263A(c)(5)(A) provides that the uniform capitalization rules do not apply to trees raised, harvested, or grown by the taxpayer other than trees bearing fruit, nuts, or other crops, or ornamental trees (except for evergreen trees more than 6 years old at the time severed from their roots).

Investment Expenses

Taxpayers that hold timber as a long-term investment incur carrying charges such as management costs, taxes, and interest. Forest management expenses include costs for development of a management plan, fertilization, or precommercial thinning. Noncorporate investors deduct these expenses as miscellaneous itemized deductions subject to the 2%-of-AGI floor (when such deductions are allowed). While these miscellaneous itemized deductions are suspended (through 2025), investors may be able to elect to capitalize these expenses under section 266.

Fertilizer Expenses

The cost of fertilizer applied after trees are established may be deducted as an I.R.C. § 162 ordinary and necessary expense [Rev. Rul. 2004-62, 2004-25 I.R.B. 1]. Such costs are similar to other deductible post-establishment costs such as the cost of fire, disease, insect and brush control in that they are performed to manage, maintain, and protect the timber stand. They are not incurred to materially add value to the timber stand, substantially prolong its useful life, or adapt the timber stand to a new or different use. Fertilizer that is applied during reforestation of land used in commercial production of timber can be deducted under I.R.C. § 194 (discussed next).

Reforestation Expenses

Reforestation expenses include costs for site preparation, seeds or seedlings, labor, tools, fertilizer, lime, herbicides, depreciation of equipment for activities that encourage natural regeneration, and treatments until the trees are growing without assistance. Qualifying taxpayers can elect to deduct up to $10,000 ($5,000 MFS) per year of reforestation expenses for each qualified timber property [I.R.C. § 194(b)(1)(B)] and elect to amortize the balance over an 84-month period [I.R.C. § 194(a)]. If the taxpayer does not elect to deduct/amortize the expenses, the reforestation expenses are capitalized under the timber basis account.

PLANNING POINTER

Deduction Is a Yearly Limit

The $10,000 limit is an annual limit. Thus, a taxpayer that completes site preparation near the end of the tax year and plants the seedlings at the beginning of the next year can deduct up to $20,000 of reforestation expenses for the individual tract of timber.

Section 194(c)(1) defines the term *qualified timber property* as a woodlot or other site located in the United States that will contain trees in significant commercial quantities and that is held by the taxpayer for the planting, cultivating, caring for, and cutting of trees for sale or use in the commercial production of timber products. Growers of Christmas and other ornamental trees do not qualify for the section 194 election. Expenses that are reimbursed by any governmental reforestation cost-sharing payments are not deductible unless the cost-sharing amount is included in gross income.

Individual taxpayers, estates, partnerships, and corporations can qualify for the deduction and amortization. The dollar limit applies at the partnership level and to each partner. Similarly, the limit applies to an S corporation and each shareholder [I.R.C. § 194(b)(2)(B)]. Trusts do not qualify for the section 194(b) deduction but may qualify for the section 194(a) amortization. Trusts and estates must apportion the reforestation expenses between the estate or trust and the beneficiaries on the basis of the estate or trust income that is allocable to each.

Section 194 Election

The section 194 election to deduct and amortize reforestation expenditures is made by claiming the deduction on a timely filed return (including extensions) for the tax year in which the costs were incurred. If the taxpayer fails to make the election, the taxpayer can file an amended return within 6 months of the due date (excluding extensions).

The taxpayer must attach a statement to the return that specifies the amounts and nature of the expenditures, and the date on which each was incurred. The statement should also state the type of timber being grown and the purpose for which it is being grown. The taxpayer must also include a separate statement for each property for which reforestation expenditures are being deducted and/or amortized under section 194.

Once the election has been made, it can be revoked only with IRS approval. Ordinarily, the request for consent to revoke the election will not be granted if it appears from all the facts and circumstances that the only reason for the desired change is to obtain a tax advantage [Treas. Reg. § 1.194-4(c)].

Disposition of Section 194 Property

If the taxpayer disposes of the trees within 10 years from the year in which the taxpayer elected to deduct/amortize reforestation expenditures, then the lesser of the gain from the disposition or the amount of the amortization deductions claimed is recaptured as ordinary income under I.R.C. § 1245. For dispositions after 10 tax years, there is no recapture. The taxpayer must file Form 4797, Sales of Business Property, to report a taxable disposition and the recaptured amount.

A disposition includes a sale of land and trees, the clear-cutting of trees, or any other purposeful destruction. Thinning and other cuttings made to improve the health of the timber stand are not considered dispositions. There is generally no recapture for property disposed of by gift or transferred at death.

A like-kind exchange or involuntary conversion is a disposition, but the potential section 1245 recapture carries over to the replacement timber if the FMV of the replacement timber equals or exceeds the FMV of the relinquished timber. If the replacement like-kind property includes no timber, the taxpayer must apply the section 1245 recapture rules as if the taxpayer sold the timber for its FMV. If the FMV of the replacement timber is greater than zero but less than the FMV of the relinquished timber, some or all of the section 194 deduction may be recaptured at the time of the like-kind exchange.

Taxation of Forest-Related Income

For a taxpayer who holds timber for use in a trade or business or for sale to customers in the ordinary course of a trade or business, the tax treatment of a sale depends on how the timber is sold. Although many taxpayers sell the standing timber, some taxpayers have the timber cut and then sell the logs. This section discusses the tax consequences of a standing timber sale. It also discusses tax on sales of cut timber and the sale of nontimber forest products.

Sale of Standing Timber

Timber business owners often sell standing timber rather than cutting the timber and selling the logs. Sales of standing timber held for more than 1 year qualify for I.R.C. § 1231 treatment whether they are lump sum sales or there is a retained economic interest [I.R.C. § 631(b)]. The net gain or loss is generally calculated as gross sale proceeds less adjusted basis and costs of the sale.

Expenses that are directly related to the sale of timber include appraiser fees, selling agent fees, and attorney fees. Cost of sale may also include the following:

- Hiring a consulting forester to solicit bids, manage logging, and/or mark the sale trees
- Paying for a land survey to establish property boundaries to prevent cutting a neighbor's timber
- Constructing a temporary logging road
- Purchasing a temporary easement to cross a neighbor's land to harvest timber from a landlocked property

Taxpayers report the sale on Form 4797.

Practitioner Note

Held as an Investment

A taxpayer may hold timber as an investment. An investor's gain or loss from the sale of standing timber is a capital gain or loss reported on Schedule D (Form 1040). For example, a homeowner who very infrequently sells timber expecting a profit has a capital gain or loss.

Sale of Cut Timber

If a taxpayer cuts the timber (or pays a contractor to cut it), and sells the cut timber in the ordinary course of a trade or business, the gain or loss is all ordinary gain or loss unless the taxpayer elects to treat the cutting as a sale under I.R.C. § 631(a). If the taxpayer makes the election, then the difference between the timber's FMV (on the first day of the tax year in which it is cut), and its adjusted basis is section 1231 gain or loss. The difference between that FMV and the net proceeds from selling the cut timber is ordinary income or loss.

To qualify for this section 631(a) election, the standing timber must be cut by the owner or by someone who has held a contract right to cut the timber for more than 1 year. The holding period must include the first day of the tax year in which the timber is cut. A contract right is an unrestricted right to use or sell the cut timber.

Making the Election

The taxpayer must make the section 631(a) election on their original income tax return (not an amended return) for the election year [Treas. Reg. § 1.631-1(c)], and calculate the gain or loss under sections 631(a) and 1231. Once the election is made, it is effective for the current sale and sales in subsequent years.

Recovery of Basis—Depletion

Timber depletion is not the same as the statutory (percentage) depletion allowance that is used for oil, gas, and minerals. Timber depletion allows a taxpayer to recover the cost of standing timber as it is cut. The taxpayer must own an economic interest in the timber when it is cut to qualify for the depletion deduction.

The depletion per unit is determined by dividing the adjusted basis in the timber account by the total volume of timber, usually expressed in terms of dollars per MBF (thousand board feet), dollars per cord, or dollars per ton. A taxpayer that sells all the timber may deduct the entire basis in the timber account. If the taxpayer sells only a portion of the timber, then the depletion per unit is multiplied by the units sold to determine the deduction amount. Taxpayers can use the depletion deduction only in years when they sell timber or are treated as selling it under a section 631(a) election.

Example 12.24
Sale of Cut Timber

Ethan Walker is in the timber business. He elected to treat the cutting of his timber as a sale or exchange under section 631(a). In September 2023, Ethan cut and sold 3,000 tons of timber. The sale price was $99,200, and Ethan paid $12,000 in harvesting costs. A consulting forester estimated the FMV of the standing timber on January 1, 2023, to be $84,000. Ethan had $10,000 basis in the timber that was harvested. He did not elect the reforestation expense amortization and received no cost-sharing payments for the planting.

Ethan's sale is reported in two steps. First, he reports a section 1231 sale on Form 4797. Second, he reports ordinary business income on Schedule F (Form 1040), Profit or Loss From Farming. His $84,000 basis reported on line 1b of Schedule F (Form 1040) is the timber's FMV on the first day of the tax year. **Figure 12.7** shows Ethan's section 1231 and section 631(a) calculations.

FIGURE 12.7
Ethan Walker's Section 1231 and 631(a) Calculations

FMV of timber cut on 1/1/2023	$84,000
Depletion allowance [($10,000 ÷ 3,000 tons) × 3,000 tons]	(10,000)
Section 1231 gain (Form 4797)	$74,000
Sale proceeds	$99,200
Cost basis of logs	(84,000)
Harvesting costs	(12,000)
Net income on sale [Schedule F (Form 1040)]	$ 3,200

Sale of Nontimber Forest Products

Landowners who have timber property may have sales of associated products (such as lighter wood from stumps or even the stumps) after standing timber is harvested. They may also sell products such as firewood and pine straw. These products are generally treated as sold in the ordinary course of business, and the gain on the sale is ordinary income.

Practitioner Note

Government Payments

Part or all of the cost-sharing payments received under certain state or federal conservation, reclamation, or restoration programs may be excluded from income under I.R.C. § 126. The following federal programs are currently available to forest landowners: Environmental Quality Incentives Program (EQIP), Conservation Reserve Program (CRP), Forest Health Protection Program (FHPP), and the Wetlands Reserve Program (WRP). See the earlier discussion (in Issue 2) of the cost-sharing exclusion for eligibility and how to calculate the exclusion.

Casualty Losses

Common casualty events for timber property include hurricanes, tornadoes, fires, floods, and snow and ice storms. Calculation of a timber property casualty loss is determined by reference to a specific property unit (SPU). This section briefly explains how the regulations and case law define an SPU for calculating a timber casualty loss. If the taxpayer has a casualty gain, the taxpayer may be able to defer the gain by purchasing qualified replacement property. This section discusses the requirements for nonrecognition of gain.

Sudden Loss

A casualty is a sudden, unexpected, and unusual event that causes damage or destruction of property. Insect and disease damage is usually not considered a casualty loss because the loss is typically over time, and not sudden.

Example 12.25
Insect Damage—No Sudden Loss

Pine Creek Timber Corp. grows, manages, and harvests pine timber for use in its wood products manufacturing facilities. A 40-acre stand of merchantable pine trees that the taxpayer had grown on its timberland was attacked by southern pine beetles. Although the beetle was indigenous to the area in normal populations, this extensive, widespread beetle attack was unexpected and unusual.

The attack caused the death of 90% of the merchantable trees in the stand within 30 days. The attack of the insects and the death of the trees rendered the wood in the trees vulnerable to the wood-destroying organisms that gradually caused the deterioration of the wood and destroyed the timber in the uncut trees. The entire process occurred over a 9-month period.

Pine Creek can deduct the loss as a section 1231 loss but not as a casualty loss. The loss was both unexpected and unusual, but it lacked the "suddenness" requirement. The lapse of time from infection to the death of the trees indicated not a sudden loss, but a loss resulting from gradual deterioration [Rev. Rul. 87-59, 1987-2 C.B. 59].

Example 12.26
Insect Damage—Sudden Loss

The facts are the same as in Example 12.25 except that Pine Creek also grows ornamental trees. Within a few days of the insect attack, the trees became worthless. Pine Creek may claim a casualty loss for the destroyed trees [Rev. Rul. 79-174, 1979-1 C.B. 99].

Calculation of Loss

When there is a casualty loss for business or investment property, the amount of the loss taken into account under I.R.C. § 165(a) is the lesser of

- the FMV of the property immediately before the casualty, reduced by the FMV of the property immediately after the casualty; or
- the adjusted basis for determining loss from sale or other disposition of the property.

CROSS-REFERENCE

Personal Casualty Losses

A taxpayer generally cannot deduct personal expenses. However, losses of personal use property (property that is not connected with a trade or business or a transaction entered into for profit) may be deductible if the losses are the result of fire, storm, shipwreck, or other casualty. For tax years 2018 through 2025, the deduction for personal casualty and theft losses is limited to losses attributable to federally declared disasters. However, taxpayers may still claim other personal casualty and theft losses (those not attributable to federally declared disasters) to the extent of any personal casualty and theft gains during the year. See the "Individual Tax Issues: Part 1" chapter in this book for a discussion of personal casualty losses.

When timber property is damaged or destroyed by a casualty, the loss is determined by reference to the single identifiable property (SIP) unit damaged or destroyed [Treas. Reg. § 1.165-7(b)(2)(i)]. Once the SIP is identified, the casualty loss is determined with reference to that specific property unit. The amount deductible is the lesser of the decrease in FMV of the SIP or its adjusted basis. Thus, the taxpayer must obtain an appraisal of the FMV of the SIP immediately before and after the casualty.

For timber property, the SIP is generally the depletion block, not the tree stand [Rev. Rul. 99-56, 1999-2 C.B. 676]. A tree stand is defined as an aggregation of trees that is sufficiently homogeneous to be distinguishable from adjoining growth. A depletion block is the area into which the taxpayer aggregates its timber according to logical standards, such as geographical or political boundaries, management areas, or manufacturing point. It is the area selected as a means of tracking the adjusted basis in the timber. The depletion block is usually significantly larger than the tree stand. [See Treas. Reg. § 1.611-3(d)(1) and *Weyerhaeuser v. United States*, 39 Fed. Cl. 410 (1997).]

Deferral of Gain

Sales of timber downed as a result of a casualty event qualify for nonrecognition of gain under I.R.C. § 1033 if the sale proceeds are used to purchase other standing timber [Rev. Rul. 80-175, 1980-2 C.B. 230]. If timber is damaged, for example, by a hurricane, there may be a gain on the sale if the adjusted basis of the timber is low.

I.R.C. § 1033 allows a taxpayer to elect to postpone gain to the extent that the proceeds are reinvested in property that is similar or related in service or use. The purchase of the replacement property must occur within the replacement period. The replacement period generally ends 2 years after the end of the year in which the gain is realized.

Qualified replacement property may include the capital costs of reforestation, establishment of new timber stands (afforestation), purchase of replacement timber sites, and the cost of purchasing controlling stock (80%) in a timber corporation [G.C.M. 39152 (December 4, 1981)].