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Tax and Succession Planning for Agricultural Businesses
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I. Estate Planning to Reduce Income Tax – <u>Basis Planning</u>

A. Portability and Increased Unified Credit

1. Portability allows for any unused applicable exclusion amount of a decedent to be used by the surviving spouse if the decedent's executor makes an appropriate election on a timely filed estate tax return that computes the deceased spouse's unused exclusion amount ("DSUE"), equal to the lesser of (1) the basic exclusion amount that applied at the predeceasing spouse's death or (2) the predeceased spouse's basic exclusion amount less the combined amount of the taxable estate plus adjusted taxable gifts of the predeceased spouse. § 2010(c)(4).
2. 2015 Exemption (adjusted annually for inflation) (§ 2010(c)(3))
   a. $5,430,000 individual
   b. $10,860,000 for a married couple
3. Advantages and Disadvantages of Portability
   a. Advantages
      i. Simplicity and flexibility
      ii. Greater sense of security for the surviving spouse
      iii. **<u>Stepped-up basis at the death of each spouse</u>**
   b. Disadvantages (to relying solely on portability)
      i. DSUE Amount is not indexed for inflation, but appreciation in the assets is included in the gross estate of the surviving spouse, unlike the growth in a bypass trust, which is **excluded** from surviving spouse's estate.

ii. The unused exclusion amount from a particular predeceased spouse will be lost if the surviving spouse remarries and survives his or her next spouse.

iii. There is no portability of the GST exemption so Bypass Trust is preferred here.

iv. Beneficiaries other than just the surviving spouse can use the assets left to a bypass trust, but portability gives solely to the surviving spouse.

v. Portability alone does not offer the usual benefits of trusts, including asset protection, asset management, and restricting transfers of assets by the surviving spouse. Consider use of a trust that qualifies as a QTIP with a partial QTIP election.

vi. A state with a state estate tax may not have comparable portability concept, which could result in additional state estate tax being owed.

4. The Black Widow Scenario

    a. A very taxpayer favorable position in the portability regulations allows the use of DSUE Amounts from multiple spouses. The regulations include an ordering rule that requires a surviving spouse to use DSUE Amount first when making taxable gifts before using the surviving spouse's own basic exclusion amount.

    b. This rule allows an individual to take advantage of DSUE Amounts from multiple spouses, so long as the individual makes a taxable gift to utilize the DSUE Amount from a particular deceased spouse before the individual is predeceased by a subsequent spouse.

B. Income Tax Basis Planning

1. Basis Step-Up

    a. Section 1014 provides that property receives a "step-up" in basis to fair market value as of the date of death of the decedent.

    b. A return is not required to receive the step-up in basis (Treas. Reg. § 1.1014-2(b)(2); Rev. Rul. 56-215).

    c. It is crucial to obtain date-of-death appraisals to document the value for basis purposes contemporaneously as proving value many years down the road will be a logistical nightmare.

2. The Past (Pre-2012)

    a. Lower exemptions

    b. Focus on bypass trust planning to take advantage of step-up and tax-free appreciation in value

    c. Low values were desirable to avoid having a taxable estate or to minimize tax

3. The Present
    a. High exemptions
    b. Portability planning and potential freedom from the bypass trust
    c. Higher values desirable for basis step-up as few individuals or couples actually have taxable estates
    d. New basis for depreciation
4. There is the potential that the IRS may use taxpayers' arguments against them in future valuation cases. Where the taxpayer once argued for steep discounts, the shoe is now on the other foot. *McCormick v. Commissioner*, T.C. Memo 1995-371, *Bonner v. U.S.*, 84 F.3d 196 (5th Cir. 1996); *Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982); *Forbes v. Commissioner*, T.C. Memo 2001-72; *McCord v .Commissioner, 120 T.C. 358 (2003).*
5. Beware taking inconsistent positions in one estate as compared to the second, last to die estate.
6. Use of Grantor Trusts
    a. Section 1014(e) limits a donor's ability to receive a step-up by gifting appreciated assets to a donee who dies within a year of the gift and passes the assets back to the donor or the donor's spouse.
    b. One may be able to avoid § 1014(e) by utilizing a grantor trust where the spouse is the sole income beneficiary.
        i. A gift of cash into a grantor trust is used to purchase low basis property. The cash is not appreciated property and the low-basis, purchased assets would receive a step-up under § 1014(b)(9).
        ii. Pursuant to Rev. Rul. 85-13, there are no income tax consequences to the transaction.
        iii. The donor would not retain any powers of the trust which would cause an incomplete gift and § 1014(e) would be avoided.
    c. Some caution is warranted, as the IRS is currently attacking sales to grantor trusts and elimination of the tax benefits of grantor trusts has been contemplated under past presidential proposals.

C. Use of Passthrough Entities for Basis Planning
    1. Ever versatile and flexible, basis planning provides yet another reason to utilize passthrough entities like partnerships and LLCs taxed as partnerships.

2. Contribution to a partnership allows deferral of the decision regarding whether to seek a step-up in basis for any particular asset as property appropriate for the step-up can be distributed to a partner in partial redemption of his or her interest when the time is right.

    a. No gain or loss recognized by the partner or the partnership because the distribution is not cash or marketable securities.

    b. If the assets have been in the partnership for more than 7 years, there are no concerns related to mixing bowl or disguised sale transactions. I.R.C. §§ 704(c)(1)(B), 737.

    c. Transferred basis limited to the outside basis of the partner's partnership interest, as adjusted.

    d. Asset is eligible for a step-up in basis under § 1014.

3. Before distribution, the partnership should also consider benefits of a § 754 election.

    a. Adjustment of inside basis under § 743(b). But this adjustment can be up or <u>down</u>!

    b. Low basis assets remaining inside the partnership benefit from basis stripped from the high basis asset distributed in partial redemption.

    c. Consider spinning smaller sub-entities off to isolate assets so as not to impose a § 754 election on all assets in a partnership if there are a multitude of assets.

    d. Once made, a § 754 election is irrevocable without Commissioner consent.

4. What you need to make this work

    a. Planning and timing to avoid mixing bowl and disguised sale rules (start now!)

    b. A mix of high and low basis assets (avoiding marketable securities)

    c. Proper advice and tax planning regarding whether and when to make the § 754 election

    d. Consider distributions of assets pre-death to get greatest step up in basis and avoid Section 743/Valuation Discount Limitations post death.

II. Conservation Easements

A. State Ad Valorem Taxes

1. Land dedicated in perpetuity for conservation purposes, used exclusively for that purpose, is 100% exempt from ad valorem taxation. § 196.26(2), Florida Statutes.

2. Land dedicated in perpetuity for conservation purposes, also used for allowed commercial purposes, is exempt from ad valorem taxation on up to 50% of the assessed value of the property. § 196.26(3), Florida Statutes. If the allowed commercial purpose includes agriculture must also comply with best management practices adopted by rule of the Department of Agriculture and Consumer Services. § 196.26(7), Florida Statutes.

3. In order to qualify for the exemption, the land must comprise of 40 or more contiguous acres OR be approved by the Acquisition and Restoration Council as fulfilling a clearly delineated state conservation policy and yielding a significant public benefit. § 196.26(4), Florida Statutes.

4. Buildings and structures on exempt land are assessed separately unless they are auxiliary to the use of the land for conservation purpose. § 196.26(6), Florida Statutes.

5. Application must be filed/renewed annually.

6. Definitions

    a. "Allowed commercial uses" means commercial uses that are allowed by the conservation easement encumbering the land exempt from taxation under this section.

    b. "Conservation purposes" means:

        i. Serving a conservation purpose, as defined in § 170(h)(4)(A)(i)-(iii), for land which serves as the basis of a qualified conservation contribution under § 170(h); or

        ii. Retention of the substantial natural value of land, including woodlands, wetlands, watercourses, ponds, streams, and natural open spaces; or

        iii. Retention of such lands as suitable habitat for fish, plants, or wildlife; or

        iv. Retention of such lands' natural value for water quality enhancement or water recharge.

    c. "Dedicated in perpetuity" means that the land is encumbered by an irrevocable, perpetual conservation easement.

B. Tax Consequences of the Sale of an Easement

1. The sale of an easement is a "realization event" that may result in the recognition of gain or loss for income taxes.

    a. Sale of a perpetual easement and retention of bare legal title is treated as a sale.

    b. Examples of Sales

i. Sale of a perpetual easement to a portion of the land to the State for the purpose of a highway, and the landowner retained no beneficial interest in the sold portion.

ii. Sale of an easement that permits and in fact causes constant flooding of the property.

iii. Sale of a perpetual conservation easement by a landowner to obtain mitigation credits.

c. In contrast, if a landowner sells a 'flowage deed' to the State providing a perpetual easement to flood designated properties at such infrequent intervals as not to deprive the landowner of any substantial beneficial use of the properties, there would not be a sale. For example, a landowner might retain the right to use the land for cattle grazing.

2. Consequences

a. Gain or loss is recognized.

b. The character of the recognized gain or loss, capital v. ordinary, is subject to the nature of the property.

c. If the landowner's use is not substantially reduced, then the sale of the easement is considered a recovery of basis. Loss is not recognized and gain is recognized only to the extent the proceeds received exceed the basis in the property. Again, the character of the gain is subject to the nature of the property.

d. Even if gain is realized, tax deferral opportunities exist to avoid gain recognition, i.e. a like-kind exchange (see discussion below).

3. Comprehensive Example

a. SFWMD purchases the perpetual right to store water on 50 acres of a 1,000 acre ranch abutting the Kissimmee River for $400,000. In addition, the SFWMD obtains a flowage deed for $500,000 to flood the remaining 950 acres at such infrequent intervals as not to deprive the rancher of the ability to continue to use the property to graze cattle.

b. The taxpayer's basis in all 1,000 acres is $1 million or $1,000/acre.

c. The easement over the 50 acres is considered a sale. The landowner will recognize a gain of $350,000 ($400,000 - $50,000) for this sale. Section 1031 is available in this instance.

d. The flowage easement over the 950 acres is not considered a sale. The landowner does not recognize gain, but the basis of its property is reduced by $550,000 to $450,000 ($1,000,000 - $50,000 [for the prior sale] - $500,000).

C. Donation of an Easement

1. Income Tax

   a. Charitable deductions are allowed for a “qualified conservation contribution” which can include certain easements. I.R.C. § 170(f)(3)(B)(iii).

   b. Qualified conservation contributions are defined in § 170(h) as a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes.

      i. Qualified real property interest

         a) The entire interest in the property other than certain mineral interests;

         b) A remainder interest in the property; or

         c) A perpetual restriction on the use of the property.

      ii. Qualified organization

         a) Generally, to be considered an eligible donee, an organization must have a commitment to protect the conservation purposes of the donation and have the resources to enforce the restrictions. A conservation group organized or operated primarily or substantially for one of the conservation purposes specified in § 170(b)(4)(A) will be considered to have the commitment required by the preceding sentence. A qualified organization need not set aside funds to enforce the restrictions that are the subject of the contribution. Treas. Reg. § 1.170A-14(c)(1).

         b) A governmental unit;

         c) A publicly supported charity; or

         d) A supporting organization that supports one of the first two options.

      iii. Conservation purposes

         a) The preservation of land areas for outdoor recreation by, or the education of, the general public;

         b) The protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem;

c) The preservation of open space (including farmland and forest land) where such preservation is for the scenic enjoyment of the general public, or pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and will yield a significant public benefit; or

d) The preservation of a historically important land area or a certified historic structure.

c. Considered a contribution of a capital asset for which you receive a deduction equal to the fair market value of the contribution.

d. The amount of the deduction is equal to the fair market value of the contribution, not its adjusted basis. Qualified appraisals are required of the property before the easement at highest and best use and then with the easement in place with the difference being the value of the contribution. The fair market value of a contribution will be reduced by the amount of the ordinary income or short term capital gain that would have resulted had the contributed property been sold at its fair market value as determined at the time of contribution.

i. **<u>Therefore, to take advantage of the deduction, the taxpayer must have held the property for the requisite time period (greater than one year) and purpose (investment) such that any gain would have qualified for long term capital gain.</u>**

ii. **<u>Note: If there is a change in equity exceeding 50% in a 12 month period, a new holding period begins for the new investors.</u>** See § 170(e)(1)(A) and § 708.

e. Deduction limitations

i. Generally

a) 30% of an individual taxpayer's adjusted gross income ("AGI") (§ 170(b)(1)(B)(i))

b) 10% of a corporation's AGI (§ 170(b)(2)(A))

c) Unused deduction may be carried forward for 5 years (§ 170(b)(1)(B))

ii. Temporary Benefits - § 170(b)(1)(E)

a) Deduction limitation for individuals increased to 50% of AGI

b) Any excess subject to a 15 year carryforward

c) Special Rule for "qualified farmers or ranchers"

1. A "qualified farmer or rancher" is a taxpayer whose gross income from the trade or business of farming (within the meaning of § 2032A(e)(5)) is greater than 50% of the taxpayer's gross income for the taxable year. (§ 170(b)(1)(E)(v)).
2. Deduction increased to 100% of AGI.
3. If the property contributed was used in agriculture or livestock production, then the property owner must retain the right to use the property for agriculture or livestock production.
4. If a corporation is a qualified farmer or rancher, the 10% limit does not apply.

d) **<u>If not extended, only applies to contributions of qualified conservation property made for tax years beginning after 2005 and before 2015. Although it has been extended before, and very well might be again, it is difficult to plan on.</u>**

2. Estate and Gift Tax
   a. Value of gifted/inherited property reduced by impact of any qualified conservation easement
   b. Donation does not incur gift or estate tax due to deduction
   c. An estate executor may elect to exclude an **additional 40%** of the remaining land value up to a maximum of $500,000. I.R.C. § 2031(c).
   d. Qualified Conservation Easements Defined (§ 2031(c)(8))
      i. A gift of a "qualified real property interest" to a "qualified organization" exclusively for "conservation purposes." See discussion above for definitions of these terms.
      ii. Does not apply to historically important land areas and certified historic structures.
      iii. Must prohibit more than de minimus commercial recreational activity.
      iv. Must be owned by decedent or family for 3 years prior to death.
   e. Special Use Valuation under § 2032A still available.

D. IRS Controversy

1. This area has become increasingly litigated as the use of conservation easements has risen in popularity with the rise of property values and advent of tax shelter opportunities.

2. Areas for attack

    a. Strict adherence to requirements

    b. Valuation issues – Qualified Appraisal

III. Section 1031 - Like-Kind Exchanges

A. Section 1031 providing for the non-recognition of gain or loss on the exchange of like-kind property is a popular mechanism for the acquisition and disposition of citrus groves and other agricultural lands. This section can be used to roll-over the proceeds received from the sale of an easement into replacement property.

B. Under § 1031(a), no gain or loss is recognized when property held for productive use in a trade or business or for investment is exchanged solely for property of a like-kind that can be held either for productive use in a trade or business or for investment. Like the other "non-taxable exchange provisions" found in the Code, § 1031 provides an exception only from current recognition of the gain realized. The realized gain is deferred until the "exchanged property" is disposed of in a subsequent taxable transaction.

C. The replacement property takes a "carried over" basis

1. The adjusted basis of the sold property, plus

2. Any additional money used to acquire the replacement property.

D. **Very strict timing rules to qualify for safe harbors (discussed below) for deferred exchanges.**

1. Deferred Like-Kind Exchanges - Under the Regulations, a deferred exchange would be defined as an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (relinquished property) and subsequently receives property to be held for productive use in a trade or business or for investment (replacement property).

2. The taxpayer is allowed 45 days from the date of the original sale to identify the replacement property but the replacement property must be acquired within 180 days of the date of the original sale.

E. Receipts must be held in an escrow account, trust, or by a "qualified intermediary" through the end of the 180-day exchange period. See Regs. § 1.1031(k)-1(g)(6). Payment must be delivered directly to the qualified intermediary who then buys the replacement property and completes the exchange with the seller.

1. Under the Regulations, if the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the

relinquished property before the taxpayer receives like-kind replacement property, the transaction would constitute a sale and not a deferred exchange, even though the taxpayer ultimately received like-kind replacement property.

2. Safe Harbors

   a. The obligation of the taxpayer's transferee to transfer the replacement property to the taxpayer is permitted to be secured or guaranteed by (a) a mortgage, deed of trust or other property interest in property; (b) a standby letter of credit; or (c) a guarantee of a third party.

   b. The obligation of the taxpayer's transferee to transfer the replacement property is permitted to be secured by cash or a cash equivalent if such cash or cash equivalent is held in a qualified escrow account or a qualified trust.

   c. Deferred exchanges are permitted to be facilitated by the use of a qualified intermediary if the taxpayer's rights to receive money or other property are limited to certain specified circumstances.

   d. The taxpayer is permitted to receive interest or a growth factor with respect to the deferred exchange, provided, the taxpayer's rights to receive such interest or growth factor are limited to certain specified circumstances.

F. Additionally, the Regulations place restrictions on the manner in which replacement property must be identified as well as the number of properties which may be identified. The Regulations limit the maximum number of replacement properties that the taxpayer could identify to: (1) three (3) properties of any fair market value; or (2) any number of properties, so long as their aggregate fair market value as of the end of the identification period does not exceed 200% of the aggregate fair market value of all of the relinquished properties.

G. <u>When conducting a like-kind exchange, special attention must be given to the class of underlying property (i.e. land, trees, irrigation systems, etc.) in order to avoid recapture under § 1245.</u>

H. The sale of an easement constitutes the sale of real property. Rev. Rul. 59-121. If an easement is sold under "threat of condemnation" or actually taken under an eminent domain action, § 1033 can be used to roll-over the proceeds received into new property. I.R.C. § 1033 has much more lenient timing rules.

I. The proceeds from the sale of credits under a rural land stewardship program constitute the sale of real property. PLR 200649028.

J. <u>Note: Section 1031 exchanges have recently been under attack in many legislative proposals from both sides of the aisle. There is the potential that this significant benefit could be eliminated or severely restricted in legislative negotiations. Planners should warn their clients to beware.</u>

IV. A Potpourri of Tax Provisions for Agriculture

A. Section 179 - First-Year Expensing of Depreciable Assets

1. Since the enactment of the Economic Recovery Tax Act of 1981, investments in certain items of tangible property, citrus trees for example, have qualified for the § 179 first-year expense thereby allowing a purchaser to deduct a portion of his initial investment before determining his depreciation in the year of purchase.

2. Limitations

    a. The § 179 expense phases out and there is a limitation on its deductibility.

    b. For tax years beginning after 2014, the maximum aggregate cost which can be taken into account for § 179 is $25,000 **unless an extender bill is passed.**

    c. This first-year expense is phased out dollar for dollar if the § 179 property placed in service during the taxable year exceeds $200,000. Therefore, if the § 179 property placed in service during a tax year exceeds $225,000, there is no § 179 deduction for that year.

    d. The deductibility of this first-year expense is also limited to the amount of taxable income derived by the taxpayer from the active conduct of any trade or business during the taxable year. Any unused § 179 expense due to the taxable income limitation, may be carried over into succeeding years.

    e. Note: This section is an item of great interest for an extender bill as the $25,000 limitation discussed above is down from $500,000 allowable in 2014. Many do not wish to see this benefit disappear, but only time will tell.

3. There has been some confusion recently regarding whether citrus trees and the like qualify for § 179. There is a reference in an IRS Audit Guide that includes information that predates the current statute that is the cause of this confusion. Since 1981, § 179 clearly supports taxpayer entitlement to deductions for those items. CCA 201234024 (May 9, 2012) (providing that taxypayers were entitled to § 179 deductions for vineyards).

B. Section 631 – Timber as a Capital Asset

1. By election, a taxpayer who owns or has the right to cut timber may treat the cutting of such timber, either for sale or for use in the taxpayer's own business, may treat the cutting of such timber as a sale or exchange. (§ 631(a))

    a. Must have owned the timber or held the right to cut the timber for more than 1 year.

b. Gain or loss from the sale of a **long-term capital asset** is recognized to the extent the fair market value of the timber on the first day of the taxable year in which the timber is cut exceeds the adjusted basis in the timber.

2. Election applies to all timber owned by the taxpayer or to which the taxpayer has a right and is binding for all future years. The Secretary may permit revocation of the election on a showing of undue hardship, but the revocation precludes further elections without the consent of the Secretary.

C. Section 268 – Sale of Land with Unharvested Crop

1. Where unharvested crops are sold with land, and the crops are § 1231 property, no deduction attributable to the production of the crops is allowed.

2. The cost of producing the crops must be added to the basis of the property sold and allocated based on relative fair market values (§ 1016(a)(11)), regardless of whether the expenses are paid or incurred in the year of the sale or exchange. Amended returns will be necessary for previously taken deductions.

3. A deduction may be taken for the portion of a crop that is harvested before the sale of the land.

D. Section 469 - Passive Activity Losses

1. Generally

a. The IRS has long sought to limit the attractiveness of investments characterized as tax shelters. One of the primary means of achieving this goal is the limitation upon the deductibility of passive activity losses. This limitation generally provides that losses generated from a passive activity may not be used to offset income generated from an active trade or business or portfolio investment.

b. Passive activity is defined to mean any activity which involves the conduct of a trade or business and in which the taxpayer does not materially participate. Therefore, if the taxpayer does not materially participate in regard to an agricultural investment, then any tax losses generated by the investment will not be deductible against income from an active trade or business, but rather will only be deductible against income from other passive activities until the investment is disposed of in a taxable transaction.

2. Taxpayers subject to passive activity loss rules

a. Individuals, estates and trusts

b. Personal service corporations

c. Closely held "C" corporations (Note: Special rules applicable to closely held C corporations (other than personal service corporations) allow offset of these losses against both passive income and ordinary income, but not against portfolio income)

3. Generally, the definition of activity tends to aggregate undertakings into larger groups. Typically everything at one location is considered a single activity, even if the individual undertakings are not similar. If a taxpayer has undertakings at different locations, the similar undertakings can be aggregated into one activity. The IRS has explained that undertakings are similar if they are vertically integrated or have predominant operations in the same line of business. Aggregating various undertakings into a single activity will make it easier for taxpayers to "materially participate" in an activity, thus excluding that activity from the passive loss rules.

4. Material Participation

   a. In order to be deemed to materially participate in an activity, the taxpayer must be involved on a regular, continuous and substantial basis.

   b. If the investment is made as a limited partner in a limited partnership, the taxpayer will be conclusively presumed to not materially participate. Investments through other entities such as partnerships and S corporations or sole proprietorships will be determined on an individual facts and circumstances basis.

   c. Safe Harbor - An individual will be treated as materially participating in an activity during any given tax year if he satisfies any one of the following tests:

      i. The individual participates in the activity for more than 500 hours during the tax year;

      ii. The individual's participation in the activity for the tax year constitutes substantially all of the participation in the activity of all participants for the year;

      iii. The individual participates in the activity for more than 100 hours and his participation is not less than the participation of any other individual for the year;

      iv. The activity is a "significant participation activity," meaning that the individual participates for more than 100 hours during the year, and the individual's aggregate participation of all his significant participation activities during the year exceeds 500 hours;

      v. The individual materially participated in the activity for any 5 taxable years during the 10 taxable years immediately preceding the taxable year;

vi. The activity is a personal service activity and the taxpayer materially participated in the activity for any 3 taxable years preceding the taxable year; or

vii. Based upon a facts-and-circumstances test, the individual participates in the activity on a regular, continuous and substantial basis during the tax year in question.

d. Facts and Circumstances Test – In addition to facts and circumstances indicating regular, continuous and substantial participation, the following must also occur:

i. No person other than the taxpayer who performs management services receives compensation treated as earned income;

ii. No individual performs management services that exceed the amount of services performed by the taxpayer, determined with reference to the number of hours worked by the taxpayer and other individuals;

iii. Participation of more than one hundred (100) hours by the taxpayer during the tax year.

e. Trusts and Estates

i. There is currently no IRS guidance regarding how a trust or an estate can achieve material participation.

ii. The Tax Section of the American Bar Association submitted comments in January 2015 in response to the Department of the Treasury's request for comments in the preamble to the Regulations under § 1411 with respect to guidance as to material participation of estates and trusts to be issued under Regulation § 1.469-5T(g).

iii. *Frank Aragona Trust v. Commissioner,* 142 T.C. No.9 (March 27, 2014)

a) This is currently the leading case regarding whether a trust materially participates for the purposes of § 469.

b) Two important holdings

1. A trust can satisfy the real estate professional exception if the trustee is an individual.

2. A trust can materially participate in a real estate business through the activity of the trustee(s), including work performed as employees, because trustees are not relieved

of fiduciary duty of loyalty when acting as an employee.

5. Special Rules for Farming Activities

   a. Section 469(h)(3) provides a special rule for determining whether certain retired or disabled individuals and surviving spouses have materially participated in a farming activity.

   b. A disabled taxpayer shall be treated as materially participating in any farming activity for a taxable year if he or she materially participated in the aggregate for 5 years in a substituted 8 year period ending on the date on which he or she became disabled and was continually disabled from that date.

   c. A surviving spouse is treated as materially participating if during the preceding 8 year period there have been periods aggregating at least 5 years during which the surviving spouse has actively managed the farming operation.

E. Section 263A - Capitalization

1. Generally, the following expenditures by farmers are treated as capital expenditures:

   a. Land;

   b. Buildings and improvements;

   c. Cars, trucks, equipment and machinery (and expenditures on the same to improve the property);

   d. Fences;

   e. Work, breeding, dairy, or sporting animals;

   f. Reforestation;

   g. Water wells (including drilling and equipping costs);

   h. Prepatory costs;

   i. Cost of defending or perfecting title; and

   j. Architect fees.

2. Exceptions for Farmers (with election)

   a. Costs of raising livestock;

   b. Plants produced;

   c. Soil and water conservation or endangered species recovery expenditures; and

   d. Fertilizer and soil conditioners.

3. Preproductive Expenses

a. Generally, amounts expended in the development of farms, orchards and ranches prior to the time when the productive state is reached may, at the election of the taxpayer, be regarded as investments of capital. Accordingly, a taxpayer may choose whether to deduct or capitalize such expenses.

   i. This election is limited to the preproductive phase.

   ii. Costs subject to the uniform capitalization rules of § 263A are not eligible for elective treatment. The election applies only to:

      a) Any animal;

      b) Any plant with a preproductive period of 2 years or less;

      c) Replanting costs of certain plants lost or damaged by casualty (see further discussion below in conjunction with § 1033); and

      d) Plants with a preproductive period of more than 2 years when a taxpayer elects not to apply the uniform capitalization rules. (Note that such an election may not be made for citrus or almond groves to the extent expenses are incurred before the close of the 4th taxable year beginning with the taxable year in which the trees were planted. § 263A(d)(3)(C))

   iii. The expense must otherwise be classified as deductible.

b. Preproductive Period - Treasury's original proposal notes, "In the case of plants, the preproductive period will begin with the time the plant or seed was first planted or acquired by the taxpayer, and would end with the time that the plant became productive or was disposed of. For example, in the case of a taxpayer developing an orchard, the preproductive period would begin with the time the seedlings or saplings were purchased by the taxpayer, and would end with the time the tree first bore fruit."

c. Section 263A applies to all real or tangible personal property produced by the taxpayer and to real or personal property acquired by the taxpayer for resale if the average annual gross receipts of the taxpayer exceed $10,000,000.

4. Costs Subject to Capitalization

   a. Section 263A reflects that both direct and indirect costs must be capitalized.

b. Direct costs include those material and labor costs directly attributable to acquiring and/or producing a plant.

c. Indirect costs, however, refers to the allocable portion of those costs that benefit production and/or acquisition of the plant such as the following:

    i. Repair expenses for equipment or facilities;

    ii. Maintenance costs for equipment or facilities;

    iii. Utilities, such as heat, light and power, related to equipment or facilities;

    iv. Rental of equipment, facilities or land;

    v. Indirect labor and production supervisory wages, including base, overtime, vacation, sick, and holiday pay, shift differential pay, payroll taxes, and contributions to a supplemental unemployment benefit plan;

    vi. Indirect materials and supplies;

    vii. Tools and equipment that are expensed;

    viii. Quality control and inspection costs;

    ix. Deductible taxes (except for state, local and foreign income taxes) that are attributable to labor, materials, supplies, equipment or facilities;

    x. Depreciation, amortization and cost recovery allowances on equipment and facilities;

    xi. Depletion, including both cost and percentage depletion;

    xii. Administration costs;

    xiii. Direct or indirect costs of an administrative, service or support function or department;

    xiv. Compensation paid to officers attributable to services;

    xv. Insurance costs, such as insurance on machinery and equipment;

    xvi. Deductible contributions to pension, profit sharing, stock bonus or annuity plans for current service costs; and

    xvii. Rework labor, scrap and spoilage. (See Regulations 1.263A-1(e)(3)(ii)).

5. Casualty Losses

    a. Casualty covers damage, destruction or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual in nature. An example relevant to agriculture is citrus canker, citrus greening, or freeze.

b. Section 1033

  i. As an involuntary conversion, proceeds received due to casualty are subject to the gain deferral rules of § 1033.

  ii. Must reinvest proceeds within 2 years of taking

    a) Allowed 3 tax years to reinvest if real property taken was used in a trade or business

      1. Trees planted in the ground are real property, while unplanted trees are not.

      2. Unharvested crops may be treated as real property

    b) 1 year extensions to reinvest may be granted by the IRS with Secretary approval.

    c) Carryover basis

    d) Pro-rata gain recognized for proceeds not reinvested

    e) Interaction with § 1245

      1. Depreciation recapture applies, resulting in ordinary income to the extent gain is recognized and depreciation deductions were taken under § 1245(b)(4).

      2. Any unrecognized recapture gain is transferred to the replacement property.

c. Section 263A(d)(2) (and Treas. Reg. § 1.263A-4(e))

  i. This special provision provides that if plants bearing an edible crop for human consumption were lost or damaged by reason of disease, drought, pests, or other casualty, then **<u>§ 263A shall not apply</u>** to any costs of replanting bearing the same type of crop, whether on the same parts of land which damage occurred or any other land of the same acreage in the United States.

    a) Replanting can take place with a higher density

    b) Costs may be expensed in the year in which they are incurred.

    c) Carryover basis

    d) No timing restriction (separate from possible USDA rules)

ii. Can reinvest among different varieties of the same crop (i.e. switch out oranges for grapefruit). There may be an argument to expand the ability to reinvest due to circumstances like citrus canker which make replanting citrus impracticable.

iii. Opportunity for Investors – Not only can the taxpayer take advantage of this opportunity, but new partners can as well, creating an incentive for investor money in replanting efforts.

a) Taxpayer must maintain a greater than 50% equity interest in replanted property.

b) Minority investors must materially participate in the replanting, cultivating, maintaining, or developing of replacement plants.

F. Section 1257 - Disposition of Converted Wetlands or Highly Erodible Croplands

1. Provides that any gain realized on the disposition of converted wetlands or highly erodible cropland would be treated as ordinary income and any loss on the disposition of such property will be treated as long-term capital loss. Section 1257(d) reflects however that the gain being recognized as ordinary income must be characterized by rules similar to § 1245 which are to be adopted in the Regulations.

2. The term "converted wetlands" is defined to include any converted wetland [as defined under § 1201(4) of the Food Security Act of 1985 (HR 2100)], held by the person whose activities resulted in such land being converted wetland, or by any other person who at any time used such land for farming purposes. The House Committee explanation reflected that, "In general, HR 2100 defines converted wetland as land that has been drained or filled for the purpose of making the production of agricultural commodities possible, if the production would not have been possible but for such action." (See Rep. 99-426, p. 652.)

3. The term "highly erodible cropland" means any highly erodible cropland (as defined under § 1201(6) of HR 2100) if at any time the taxpayer used such land for farming purposes (other than the grazing of animals). Again, the Committee Reports define the term "highly erodible cropland" as that land which "...is classified by the Department of Agriculture as class Ive, VI, VII or VIII land under its land capability classification system, or that would have an excessive average annual rate of erosion in relation to the soil loss tolerance level, as determined by the Secretary of Agriculture." (See Rep. 99-426, p. 652.)

4. Section 1257(c)(3) provides that land which is tainted as converted wetland or highly erodible cropland will carry that taint with it to any successor-in-interest from the taxpayer if the successor-in-interest has a

basis which is determined (in whole or in part) by reference to the adjusted basis of the land in the hands of the taxpayer.

5. Impact

    a. If property subject to § 1257 is disposed of at a loss, the loss is subject to the capital loss limitations and will not receive more favorable ordinary loss treatment.

    b. The timing of the recognition of the gain under § 1257 is impacted by § 1257(d) which reflects that ordinary income from the disposition of converted wetlands or highly erodible croplands will be characterized as § 1245 recapture income. This means that, upon the disposition of property characterized as a converted wetland or highly erodible cropland in an installment sale, the ordinary income portion of the gain will be recognized all in the year of sale and not ratably over the payment terms of the note. There are also other limitations including limitations of charitable contributions under § 170(e) for property subject to § 1245 recapture.

G. Section 464 - Prepayment of Expenses

1. Section 464 generally requires taxpayers using the cash method of accounting to capitalize prepaid farm supplies which exceed 50% of the expenses incurred in the farming business (including depreciation, during the taxable year.

2. Farm-related taxpayers, meaning (i) those whose principal residence is on a farm, (ii) whose principal occupation is farming, or (iii) who is a member of the family of a taxpayer described in (i) or (ii) above, who do not prepay, in the aggregate, 50% or more of their farming expenses during a 3-year period are exempted from these capitalization requirements. (See § 464(b).)

H. Section 175 - Limitation on expensing of soil and water conservation expenditures

1. Generally, § 175 of the Code allows a taxpayer engaged in the business of farming to treat as currently deductible expenses amounts paid or incurred during the taxable year for soil and water conservation, or for the prevention of erosion of land used in farming, subject to the limitation of § 175(b). Section 175(b) limits the availability of this deduction to 25% of the taxpayer's gross income from farming.

2. Section 175 also requires that any expenditures incurred which would otherwise be deductible under § 175 shall not be deductible unless the expenditures are consistent with the plan (if any) approved by the Soil Conservation Service of the Department of Agriculture for the area in which the land is located or if there is no such plan, any soil conservation plan of a comparable state agency. The Conference Committee Report reflects that though prior approval of a taxpayer's

particular project does not need to be obtained by the soil conservation service or a comparable state agency in order for the expense to qualify under § 175, there must be an overall plan for the taxpayer's area that has been approved by such an agency in effect at any time during the taxable year.

3. Section 175(c)(3)(B) disqualifies any expenditures in connection with the draining or filling of wetlands or preparation of land for a center pivot irrigation system as expenses deductible under § 175(a). Crucial definitions of terms used in this new section are noticeably absent. It would appear due to the location of this proposal in the Act near new § 1257 discussed above, that its terms, such as "wetlands," would be synonymous with similar terms used in § 1257. Clear, concise and restrictive definitions of these terms need to be adopted in the tax code or regulations, or else this limitation could effectively preclude most new agricultural development in the State of Florida and other Southern lowland states from qualifying for the § 175 soil and water conservation expense.

I. Section 448 - Method of Accounting

1. Section 448 limits the availability of the cash method of accounting for C corporations and partnerships which have C corporations as a partner.
2. Provides a special exception for farming businesses as long as they are not characterized as "tax shelters" or required to utilize the accrual method of accounting under § 447.

V. One Last Thing - 3.8% Tax on Net Investment Income

A. The Affordable Care Act imposed a new 3.8% tax on the “net investment income” of individuals having modified adjusted gross income of over a threshold amount ($250,000 in the case of taxpayers filing a joint return and over $200,000 for other individual taxpayers) (the “**NII Tax**”).

1. The NII Tax, if it applies, is in addition to the regular income tax.
2. NII Tax also applies to estates and trusts.
3. NII Tax does not apply to S corporations, partnerships or LLCs, but such entities must report each owner’s share of applicable net investment income on the owner’s Form K-1.
4. NII Tax applies to the lesser of “net investment income” or the taxpayer’s modified gross income above the threshold.

B. Net Investment Income includes Portfolio Income, Other Business Income and Net Gains; but does not include such income items if the income item derived in the ordinary course of a business that is active (not passive) as to the taxpayer for such tax year (“**Active Business Exception**”).

1. Portfolio Income is gross income from interest, dividends, annuities, royalties and rents (unless such items fall within the Active Business Exception).

2. Other Business Income is income from a trade or business in which the taxpayer is passive.

3. Net Gains means the net gain from the sale or disposition of property that does not meet the Active Business Exception.

C. Active Business Exception for Passthrough Entities:

1. The determination as to whether income is derived in a trade or business is made <u>at the entity level</u>.

2. The determination as to whether the activity is passive is made <u>at the owner level</u>.

3. Existing passive activity loss rules under IRC § 469.

D. NII Tax only applies to income/gains otherwise subject to tax (gains taken into account in computing taxable income).

1. Gain not recognized in a like-kind exchange is not subject to NII Tax.

2. Any <u>excluded</u> gain on sale of residence is not subject to NII Tax.

3. For sales on the installment method, NII Tax for the tax year applies to that portion of the gain recognized in the tax year.

4. NII Tax does not apply to wages or income subject to self-employment tax.

E. Examples:

1. <u>Investment Real Estate</u>. Farmer is the sole member of an LLC, which owns one commercial rental property rented to one tenant on a triple net basis with no services provided. Subject to NII Tax.

2. <u>Operating Income of Passthrough Entity</u>. Taxpayer is a shareholder of an S corporation, which operates a ranch; taxpayer works full-time in running the ranch. The ranch generates an operating profit. Because the S corporation owner actively participates, his share of S corporation income is not subject to NII Tax. Same ranch as in prior example, but the taxpayer is a passive investor in the S corporation and does not participate in the activities. For the S corporation passive owner, his share of S corporation <u>operating</u> income is subject to NII Tax.