Agricultural Law Press

Publisher/Editor
Robert P. Achenbach, Jr.
Contributing Editor
Dr. Neil E. Harl, Esq.

* * * *

Issue Contents

Agricultural Law Digest

Volume 9, No. 16 August 28, 1998 ISSN 1051-2780

SUGGESTED LEGISLATION FOR THE AGRICULTURAL SECTOR

— by **Neil E. Harl***

In recent days, the Ways and Means Committee of the U.S. House of Representatives has shown interest in passing legislation addressing tax problems of farmers. That effort seems to have the support, also, of the House Committee on Agriculture.

The following items have been submitted to the Committees for consideration. Special thanks is due Roger McEowen, Kansas State University, for his contributions to the following list.

1. The Congress has passed and the President has signed legislation advancing payments (due under production flexibility contracts in 1999) to October of 1998. Producers have the option of receiving the 1999 payment in 1998. Under current tax law, the payments will likely be deemed to be constructively received in 1998 even if payment is not actually received until 1999. *Rev. Rul. 68-44, 1968-1 C.B. 191*, held that if farm program payments are made available in a year prior to the time of regular payment with an option in the recipient to accept payments or to defer payment to the following year, the amount made available is includible in income in the earlier of the year of actual payment or the year made available to the taxpayer.

It is suggested that payment advances not be treated as constructively received but be taxed on actual receipt. Legislation is needed to accomplish that result.

2. For many years, federal disaster payments and crop insurance proceeds have been eligible for deferral to the following taxable year if the taxpayer is on the cash method of accounting and the taxpayer has traditionally carried over the crop in question to the following year. *Notice 89-55, 1989-1 C.B. 696*, has made it clear that agreements with insurance companies providing for payment without regard to actual crop losses of the insured do not constitute insurance payments for purposes of deferral under I.R.C. § 451(d). That would suggest that the newer types of crop insurance such as Crop Revenue Coverage (CRC), Revenue Assurance (RA), Income Protection (IP), Group Risk Plan (GRP), Market Value Protection (MVP) or Replacement Coverage (RC) are not eligible for deferral.

It is suggested that I.R.C. § 451(d) be amended to allow deferral for the various types of crop insurance coverage including revenue assurance plans.

3. In late 1995, the U.S. Tax Court decided a case, *Mizell v. Commissioner*, *T.C. Memo. 1995-571*, holding that the lease of property to an entity in which the lessor is also an employee or partner may result in treatment of the lease payments as self-employment income. The *Mizell* case involved a crop share lease of land to a family farm partnership. The court focused on the term "an arrangement" in I.R.C. § 1402(a)(1) which encompassed the taxpayer's involvement as a partner as well as involvement under the lease. Later, IRS issued *Ltr. Rul. 9637004, May 1, 1996*, which applied the same

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

Agricultural Law Digest is published by the Agricultural Law Press, P.O. Box 50703, Eugene, OR 97405 (ph/fax 541-302-1958), bimonthly except June and December. Annual subscription $100.

analysis to rental of land and personal property to a corporation and cited *Mizell* with approval.

Legislation has been introduced to change "an arrangement" to "a lease agreement" in I.R.C. § 1402(a)(1). *S. 529, H.R. 1261, 105th Cong., 1st Sess. (1997).* That amendment was not included in TRA-97 because the ground rules for that legislation did not permit amendments affecting social security. It is suggested that the amendment be enacted inasmuch as a large number of farm and ranch businesses are structured in a manner that assures additional self-employment tax liability.

4. For several years, a refundable income tax credit has been provided for individuals with earned incomes below a specified amount. The credit is not available if "disqualified income" exceeds $2200. Disqualified income includes "capital gain net income." Although "capital gain net income" does not include income from the sale of Section 1231 assets (such as gain from the sale of breeding stock or dairy animals), IRS disagrees and believes Section 1231 gains should be included in disqualified income.

Legislation has been introduced to amend I.R.C. § 32 to provide specifically that the statute means what it says and that Section 1231 gains or losses from the sale of livestock should not be included in disqualified income. *S. 775, H.R. 1800, 105th Cong., 1st Sess. (1997)*. However, that legislation was not included in TRA-97. With some liquidation of dairy and beef herds expected, and with pressure on farm income, this is a major issue. It is suggested that the amendment be enacted.

5. TRA-97 enacted income averaging for those "engaged in a farming business" for a three-year period, 1998, 1999 and 2000. With farm income expected to be highly volatile over the next several years, this is an important provision. However, several amendments are urged to the 1997 legislation.

a. First, it is suggested that the legislation be made permanent. Legislation has been introduced to that effect. *S. 1879, 105th Cong., 2d Sess. (1998)*.

b. Second, the legislation requires that assets producing averageable income be held for "a substantial period" but that period is not defined and no guidance has been received. It is suggested that the "substantial period" requirement be repealed or be defined in some manner legislatively.

c.Uncertainty exists over whether those who report income on Form 4835 (principally retired farmers who are renting out their land under a crop share or livestock share lease) would be eligible for income averaging. It is suggested that such individuals be made eligible as well as the various types of "pass-through" entities.

6. In 1954, Congress enacted I.R.C. § 175 which allows an income tax deduction for soil and water conservation expenditures. In general, those cash-renting their land to a tenant have not been eligible.

Because many farm and ranch businesses are structured in two-entity form with one entity holding the land and another entity carrying on the farming or ranching operation, it is suggested that the statute be amended to allow cash renting to a family member or family-owned entity as tenant as well as cash renting by a landowner who had materially participated for five or more of the last eight years before retirement or disability. Similar legislation has been introduced. *S. 429, 105th Cong., 1st Sess. (1997).* This would be consistent with the requirements for special use valuation and the new family-owned business deduction.

7. A 1995 District Court opinion, *Everson v. U.S., 95-1 U.S.T.C. ¶ 50,150 (D. Mont. 1995), aff'd, 108 F.3d 234 (9th Cir. 1997)*, held that trees and shrubs are not depreciable even though used in the trade or business for soil conservation, water conservation or windbreak purposes.

It is suggested that legislation be enacted amending I.R.C. § 168 to allow a depreciation deduction for trees and shrubs used in the trade or business of farming or ranching as 15-year property (land improvements).

8. The Agricultural Credit Act of 1987, which provided for restructuring loans held by the Farm Credit System and by then-FmHA (now the Farm Service Agency), authorized shared appreciation mortgages as a work-out concept for troubled loans. Apparently, shared appreciation mortgages (SAMs) were used in a substantial number of workouts. Unfortunately, the only known authority for deducting the additional payments as contingent interest is in *Rev. Rul. 83-51, 1983-1 C.B. 48*, which involved a residential SAM and the ruling cautions that the conclusions are not to be applied to a commercial or business loan. Moreover, the issue has been on the "no rulings" list for several years. *Rev. Proc. 94-3, 1994-1 C.B. 447*.

It is suggested that the position of Rev. Rul. 83-51 be extended legislatively to SAMs involving trade or business property.

9. For many years, meals provided on the business premises for the convenience of the employer have been deductible by the employer and excludible from income by the employees. Although the U.S. Tax Court and the Third Circuit Court of Appeals have allowed the purchase of groceries to be included in "meals," the Ninth Circuit Court of Appeals in a 1971 case held otherwise.

It is suggested that groceries be deemed to be meals for this purpose if prepared into meals by a corporate employee.

10. The statute dealing with deductions for passive activity losses, enacted in 1986, allows a $25,000 deduction for "rental real estate activities," in which the taxpayer actively participates. The temporary regulations issued under I.R.C. § 469 took the position that a 50:50 share lease was a joint venture and not a "rental real estate activity." This conclusion was reached despite the fact that cash rent leases and non-material participation share leases both produce income which is not subject to self-employment tax and have been treated similarly for other purposes. An extended debate was carried on in the pages of *Tax Notes* from November of 1990 through March of 1991, virtually all critical of the temporary regulations. However, nothing has been done to change the regulations although we were told by the Department of the Treasury that a statutory solution would be sought.

It is suggested that land rented under non-material participation share leases be eligible for the deduction for "rental real estate activities."

11. In general, discharge of indebtedness produces ordinary income to the taxpayer. However, there are five exceptions to that general rule—(a) those in bankruptcy, (b) those insolvent not in bankruptcy, (c) those with real property business debt, (d) solvent farm debtors and (e) those with what would otherwise be discharge of indebtedness income from purchase price reduction. The latter typically involves a renegotiation of the selling price for land purchased under a land contract or contract for deed by a financially troubled borrower. Any reduction in purchase price agreed upon must be accompanied by a comparable reduction in income tax basis for the assets. For depreciable assets such as buildings, fences and feeding floors, the item may have been depreciated out and has no basis.

It is suggested that any reduction in income tax basis required can be accomplished by reducing the basis of any assets used in the trade or business. This would allow reduction of the basis to the land rather than triggering more income tax liability for an already financially troubled taxpayer and would be in keeping with the relief character of the statute (I.R.C. § 108(e)(5)).

12. The low farm prices are certain to lead to farm and ranch bankruptcies. Several suggestions are made to facilitate the bankruptcy and debt restructuring processes—

a. Chapter 12 bankruptcy is scheduled to sunset on September 30, 1998. Legislation is pending to make the provision permanent.

It is strongly suggested that Chapter 12 bankruptcy be made permanent before October 1, 1998.

b. The Bankruptcy Tax Act of 1980 was never amended to add chapter 12 bankruptcy to the chapters (7 and 11) for which a new tax entity is created on filing. Accordingly, taxpayers in chapter 12 bankruptcy do not have the same planning opportunities as are available to chapter 7 and 11 filers. This is especially important to farm and ranch taxpayers because of the substantial amount of gain typically involved in financially troubled farm and ranch businesses.

It is suggested that I.R.C. § 1398 be amended to add chapter 12 to the chapters for which a new tax entity is created upon bankruptcy filing.

c.Abandoned property in bankruptcy has posed a serious obstacle to a "fresh start" which is one of the two major objectives of bankruptcy in this country. The problem is that when assets are abandoned to the debtor (where the property is worth less than what is owed on it) under 11 U.S.C. § 554, two Courts of Appeal have held that the debtor rather than the bankruptcy estate bears the income tax liability.

It is suggested that legislation be enacted which would require the gain on abandoned property to be taxed to the bankruptcy estate. This has impacted adversely farm and ranch firms in particular because of zero income tax basis on many assets.

13. The family-owned business deduction, enacted as an exclusion in 1997 and converted to a deduction in 1998 legislation, was badly flawed as originally enacted. The 1998 amendments addressed serious problems with pre-death and post-death cash renting but several problems remain which must be addressed in order for the concept to be fully workable.

a. The provision requires that assets, to be eligible for the deduction, must have been owned for five of the last eight years before death. That is a serious problem for crops, raised livestock and even machinery.

Language has been provided to the Senate Finance Committee and Joint Committee on Taxation in 1998 specifying that the holding period would not apply to inventory or inventory-like property or to depreciable assets used in the business. It is urged that this amendment be enacted.

b. The FOBD statute as originally enacted made no provision for post-death disposition of assets during the recapture period. Accordingly, any sale of crops or livestock would lead to recapture. When this problem was called to the attention of the conference committee in late July, 1997, a paragraph was added to the conference committee report indicating that recapture should not occur upon sale or exchange of such assets as grain or machinery in the course of business. However, it was too late to add a provision to the statute. Efforts to amend the statute in 1998 were unsuccessful.

It is suggested that legislation be enacted providing that post-death dispositions in the course of business not cause recapture. An even better solution would be to adopt the I.R.C. § 6166 approach which allows up to 50 percent of the assets to be transferred without accelerating the deferred tax.

c. At present, interest begins to run in the event of recapture on the date the federal estate tax was due, not on the date of the recapture event. This is a punitive provision.

It is suggested that the provision be amended to specify that interest would begin on the date of the recapture event. This would conform the provision to the recapture treatment under special use valuation (I.R.C. § 2032A).

14. Since 1986, when the last amendment was made to I.R.C. § 464 on prepaid farm expenses, farmers and ranchers have been allowed to deduct on a prepurchased basis a maximum of 50 percent of total deductible farming expenses not counting the prepaid expenses. Two exceptions were provided for "qualified farm-related taxpayers," one of which is for "extra ordinary circumstances."

It is suggested that Congress specify that the 1996 farm bill be deemed such an "extra ordinary circumstance" because of the increased expenditures under the 1996 legislation since land is no longer idled.

15. A problem of some significance under special use valuation (and under the family-owned business deduction) is that there is no authority on post-death mortgaging of assets as to whether post-death mortgaging would constitute a recapture event.

It is suggested that an amendment be enacted for both I.R.C. § 2032A and I.R.C. § 2057 providing that post-death borrowing using assets subject to the respective elections is not a recapture event so long as the resulting funds are used in the business or for the purchase of assets used in the business.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

FEDERAL TAXATION-*ALM* § 13.03[7].*

EARNED INCOME TAX CREDIT. The taxpayer filed for Chapter 7 on October 20, 1997. The taxpayer listed on Schedule B an Earned Income Tax Credit (EIC) for the 1997 tax year. The taxpayer argued that the EIC was not property of the estate since it was neither a legal nor an equitable interest of the taxpayer as of the commencement of the case. The court held that an EIC was property of the bankruptcy estate, even when the case is filed before the end of the tax year for which the EIC was claimed. ***In re*** **Johnston, 98-2 U.S. Tax Cas. (CCH) ¶ 50,625 (Bankr. 6th Cir. 1998)**.