2022 NATIONAL INCOME TAX WORKBOOK

CHAPTER 3: AGRICULTURAL AND NATURAL RESOURCE TAX ISSUES
CONTACT INFORMATION

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Farm Income & Profitability

• RECORD PROFITABILITY IN 2021 DESPITE THE CHALLENGES OF COVID, DROUGHT AND INCREASED INPUT COSTS

• TREND LINE YIELDS AND COMMODITY PRICE IMPROVEMENT IMPORTANT

• AVERAGE NFI (PROFIT) $473,185 MEDIAN NFI $310,771

• WIDE VARIATION – HIGHEST INCOME IN YEARS
FINANCIAL POSITION - Solvency

• 20% NET WORTH GROWTH
• CONTINUED LIQUIDITY IMPROVEMENT
• TOTAL DEBT/ASSET IS GOOD
• WIDE VARIATION - NEED PROACTIVE MANAGEMENT
Corn Cost of Production on Cash Rented Acres
Operator labor & Government payments included

Average
Low 20%  High 20%
Soybean Cost of Production on Cash Rented Acres

Per Bushel

$0.00 $2.00 $4.00 $6.00 $8.00 $10.00 $12.00 $14.00


- Average
- Low 20%
- High 20%
CHAPTER ISSUES

• Issue 1: Farm Income Averaging
• Issue 2: Farm Rental Property
• Issue 3: Borrowing and Lending Tax Issues
• Issue 4: Corporate Reorganizations
• Issue 5: Retiring a Farm Asset
ISSUE 1: FARM INCOME AVERAGING

- Added as I.R.C. §1031 by TRA 1997
- Still underutilized
- 2004 study showed average savings of $4,434 by 50,800 farmers – 23% savings
- Averages the tax rates that apply to current year farm income using tax brackets from 3 prior years
DEFINITIONS

• Election year – year of the election
• Base years – 3 prior years
• Electible farm income – reduced by NOLs, includes farm asset sales (except land) and S corp shareholder wages
• Elected farm income – amount taxed at base-year rates
• Farming business – trade or business under I.R.C. §263A(e)(4)

Page 77 – farm related QBI deduction reduces farm income
EX. 3.1 ELECTIBLE FARM INCOME

- $52,500 ordinary –
  - Net Schedule F
  - plus tractor gain

- $2,000 capital gain –
  - livestock gain
  - limited to net capital gain

FIGURE 3.2
Bill and Jane Farmer – Tax Return Income and Farm Income

<table>
<thead>
<tr>
<th>Income Item</th>
<th>Tax Return Income</th>
<th>Farm Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jane’s salary</td>
<td>$40,000</td>
<td>0</td>
</tr>
<tr>
<td>Interest income</td>
<td>1,000</td>
<td>0</td>
</tr>
<tr>
<td>Capital loss on stock</td>
<td>(3,000)</td>
<td>0</td>
</tr>
<tr>
<td>Farm income</td>
<td>50,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Gain on sale of breeding livestock</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Gain on sale of tractor regularly used</td>
<td>2,500</td>
<td>2,500</td>
</tr>
<tr>
<td>in the farming business</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$95,500</td>
<td>$57,500</td>
</tr>
</tbody>
</table>
Crop share landlords may qualify for farm income averaging

Written agreement and timing are crucial

Written agreement must be signed before tenant begins significant activities on the land

Landlord need not materially participate

Fixed rent does not qualify
1. Subtract elected farm income (EFI) from election-year taxable income
   - Calculate tax on balance using election-year rates

2. Add 1/3 of EFI to each of the 3 base years
   - Use tax rates and rules for each of those years

3. Add the increase in tax for each base year to the tax calculated in Step #1
• Goal is to fill lower tax brackets of the base years
• However, EFI must be distributed equally to the base years in the income averaging calculation
• The benefit of income averaging is maximized when -
  ➢ the average marginal tax rate for the base years (including EFI)
  ➢ equals the marginal tax rate on the residual election year income (Ex. 3.2)
EX. 3.2 CALCULATIONS

- 2021 income of $85,000
- Almost $45,000 in the 22% bracket
  - Adding $10,000 to 2018, brings taxable income up to 22% tax rate
  - So, EFI: 3 x $10,000 equals $30,000
  - $30,000 from 22% 2021 rate to 10% rate in each base year
  - Saves $3,000 in tax
- Stay tuned, we can do better
Income averaging is just about tax rates.
Actual taxable income is unaffected for election year and base years.
Farm income averaging will not affect other calculations tied to gross income, adjusted gross income, or taxable income.
• Daisy still had almost $15,000 of 2021 income being taxed at the 22% rate
• She still had 2 years with unused 12% rate brackets
• Average base year marginal rate is 15.33%
• Best to average all income out of the 2021 22% bracket
• Elected farm income of $44,475 saves $3,970
EFFECT ON SUBSEQUENT ELECTIONS

- In future years, for purposes of income averaging only:
  - Current year taxable income is reduced by EFI when used as a base year
  - Taxable income of a base year will be that year’s taxable income increased by that year’s share of earlier EFI additions (Ex. 3.4)
- Income tax for each year used as a future base-year will be the tax calculated after any earlier year election
• Planning Pointer
  ➢ Income average without current benefit
  ➢ Move income to prior years for lower base years in the future
  ➢ Can amend prior returns
  ➢ “Full” base years drop off after 3 years

• Practitioner Note – test software with a few “what ifs”
FISHING BUSINESSES QUALIFY

- Fishing is as defined in the Magnuson-Stevens Fishery Conservation and Management Act
- Deduction for deposits into the Merchant Marine Capital Construction Fund
- Farming and fishing businesses of the same taxpayer must be combined when income averaging
• Sale of assets other than land may qualify
  ➢ “Regularly used in the business of farming for a substantial period of time”
  ➢ Only if the property is sold within a reasonable time after the farming business ceases (1 year presumption)
  ➢ Ex. 3.6

Sale or redemption of partnership qualifies to extent attributable to underlying qualifying assets
• Depreciation recapture is taxable in the year of sale even if an installment sale is used

• Farm income averaging can effectively spread the gain from depreciation recapture on qualifying farm assets over 4 years
NEGATIVE TAXABLE INCOME IN BASE YEARS

- Base year taxable incomes can be negative.
- However, taxable income must be increased for any deduction which will provide benefit in another tax year.
- Generally, this requires an add-back of an NOL arising in or carried into a base year to the extent there is a carryover from that base year.
- Ex. 3.7 negative $8,150 taxable income due to standard deduction is okay.
AVERAGING CAPITAL GAINS

• Electible gains from farming cannot exceed net capital gain
• Like ordinary income, any elected capital gain must be equally divided among the 3 base years
• Elected capital gain added to a base year cannot be offset by any unused capital loss for that year
• Ex. 3.8 illustrates the net capital gain limit and equal allocation requirement
Income averaging has no effect on SE tax

Using income averaging rather than other tax planning tools may be better for the high-income farm taxpayer

- The OASDI (12.4%) component of SE tax is capped at $147,000 of earnings for 2022
- Then income averaging could reduce the effective income tax rate depending on base year tax rates
• Terms of rental agreements may have significant tax consequences
• Great variety of arrangements exist
• Legislative changes over the last 10 years warrant a review
• Handling tenant improvements to the property
• Personal property rentals – for both asset owner and asset user
CASH LEASE OF REAL PROPERTY

• Generally reported on Schedule E
• Would only be SE income if the agreement requires the landlord to materially participate in the operation and the landlord actually does so
• Cross-References:
  ➢ Cash rent may be eligible for QBI deduction if a trade or business, or a self-rental
  ➢ Conservation Reserve Program payments may be SE income
• Self-rental of farmland is not necessarily SE income
  ➢ However, rent in excess of fair rental value combined with a nexus between the lease and an arrangement in which the lessor materially participates can trigger SE tax

• *Martin v. Commissioner* is foundational case

• Structure arrangement to mirror *Martin* case Ex. 3.9
Cash rent landlords are not in the business of farming

Do not qualify for soil and water conservation deduction, section 179 expense, farm income averaging, etc.

Bonus depreciation is okay on qualifying assets
Generally, rental activities are passive, except:
- Real estate professionals
- Self-rentals
- Material participation crop share leases

Generally, passive losses are limited to passive income, except:
- Active participation rental special allowance

Now, the details and exceptions
Less than 30% of the unadjusted basis of the rental property is depreciable

Then, cash rent net income is nonpassive, but losses are still passive

Ex. 3.10 Jerry cannot offset his cash rent income from farmland (nonpassive) with his allocated loss as a limited partner (passive)
$25,000 LOSS ALLOWANCE

• Active participation by a natural person landlord allows $25,000 of rental losses against nonpassive income
• Allowance phases out for MAGI over $100,000 and is eliminated at $150,000
• No allowance for MFS if living together during year
• Less stringent requirements than material participation
• Property is rented to a trade or business in which the taxpayer materially participates
• Rental income is recharacterized as nonpassive unless
  • Rental is incidental to a development activity
• Rental losses continue to be passive
• Self-rental code “7” is used on Schedule E reporting
• Ex. 3.11 illustrates
SELF-RENTALS AND GROUPING

• Self-rental rule applies to each property, not activity
• Therefore, grouping has no effect on the rule
• Ex. 3.12
  • 2 properties, each rented to separate S corp operations
  • Materially participate in the S corps
  • Properties are grouped into one activity
  • Regardless, $35K passive loss on one property cannot offset $120K nonpassive loss on the other property
  • MAGI too high for $25K allowance, if applicable
• Important rule applicable here
• Suspended passive losses can be used to offset future nonpassive income from the same property
• So, $35K suspended loss from Ex. 3.12 could be deducted if that property generates a self-rental profit (nonpassive) in a future year
• Rents are generally subject to NIIT except
  • rents derived in the ordinary course of a trade or business
  • self-rental income recharacterized as nonpassive
• NIIT is 3.8% of applicable income for higher income taxpayers
• See 2017 tax workbook
• Ordinary and necessary business expense on Sch F
• Prepayment okay but limited by 12-month rule
• Flex leases provide for bonus payment based on production and are generally treated as cash rent
• Landlord receives a share of commodity produced
• Landlord tax treatment hinges on material participation
• Reported on Sch F subject to SE tax if
  • written or verbal agreement requiring material participation
  • and material participation actually occurs
• Without material participation report on Form 4835 and then Sch. E
MATERIAL PARTICIPATION

• Can be either direct and/or by giving directives
• Landlord meets any 1 of 4 tests
  • The first test requires landlord to perform at least 3 out of 4 actions
• Ex. 3.13
  • Landlord pays 50% of inputs and provides equipment
  • Only 2 of the 4 actions required for Test #1
  • No material participation so reports on Form 4835

PP. 89-90
• Actions of an employee or agent of the landlord are not attributable to the landlord

• These actions therefore are not considered in determining material participation

• Ex. 3.14 Hired farm manager now inspects the farm and participates in farm operating decisions

  ➢ Does not affect Test #1 results
TAX PROVISIONS AVAILABLE TO CROP SHARE LANDLORDS

• Soil and water conservation expenses
  • Engaged in business of farming if income is based on production
  • Expense available subject to 25% of farm income limit

• Sec. 179 if actively conducting a trade or business
  ➢ Requires “meaningful participation” – a lesser standard than material participation
  ➢ However, noncorporate lessor rules apply 😞
Farm income averaging includes crop share income if written agreement is signed before tenant begins activity.

Estimated tax payment rules:
- Income reported on Form 4835 counts as farm income.
- No quarterly estimates if 2/3 or more of gross income of current or preceding year is from farming.
  - Option to file and pay by March 1, or make 1 estimated payment by Jan. 15, 2022.
  - 2022 filing problem regarding Form 7203 and waiver of penalty.
• Typical non-materialla participating crop share leases:
  • are passive activities
  • are subject to NIIT

• Tenant reports no rent expense, simply has less income
TENANT IMPROVEMENTS

- Subject to usual depreciation rules without regard to lease term. Ex. 3.15 Polly depreciates tile over 15 years
- Planning Pointer – ok for bonus or Sec. 179
- Abandonment – tenant deducts remaining ATB as loss
- Rent income to landowner if made in lieu of rent – see Note p. 93
- Purchase by landowner at termination
  - Gain or loss to tenant (Examples 3.16 and 3.17)
  - Depreciable basis to landowner if placed in service
LEASING PERSONAL PROPERTY

- Self-employment Tax
- Passive Activity Limitations
- Net Investment Income Tax
- Is it a Lease or Installment Purchase?
Subject to SE tax if
- Not part of a real property lease, and
- The activity is a trade or business

Trade or business standard – regularly and continuously

Reporting
- Sch. C if trade or business - Ex. 3.18 – QBI deduction
- Otherwise, Schedule 1, line 8k and expenses on line 24b
Generally, income from the lease of personal property is subject to passive activity loss rules.

Two exceptions if the taxpayer materially participates in the activity:

- 7 day or less exception
- 30 days or less exception
• Not considered rent if average customer use is 7 days or less
• Presumption is that customer is paying for service
• Ex. 3.19 – payments for birthday party animals
  • not considered rent
  • then must consider tests for material participation
30 DAYS OR LESS EXCEPTION

- Average use by customers is greater than 7 days but not more than 30
  - Income is rent, *unless*
  - Taxpayer provides significant personal services

- Ex. 3.20
  - Average rental 15-20 days but Derek provides no services = rent
  - If Derek delivered, provided the operator, and maintained the equipment, it would not be a rental activity – could still be passive
Rentals income is generally subject to NIIT.

Therefore, if the taxpayer regularly and continuously engages in the equipment rental, the activity would not be passive and NIIT would not apply.
Operating Lease

• Pay for use of equipment for a term
• Lessee deducts rental payments on Schedule F
• Not a rent-to-own arrangement
• If lessee wants to purchase at end of term, price must be approximate FMV
Capital Lease

• A purchase over time or conditional sales contract
• Asset transfers to “lessee” at end of term
• Facts and circumstances test – 6 factors to consider
• No deduction for lease payments
  • Depreciate the purchase price
  • Expense interest portion of payments
• Trade-in on either operating lease or capital lease must be treated as a sale and report on Form 4797

• Under a capital lease, the trade-in value will be included in the purchase price and depreciated (Ex. 3.21)

• Under an operating lease, the trade-in value will be treated as additional rent paid and recovered over the term of the lease
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