2022 NATIONAL INCOME TAX WORKBOOK

CHAPTER 3: AGRICULTURAL AND NATURAL RESOURCE TAX ISSUES

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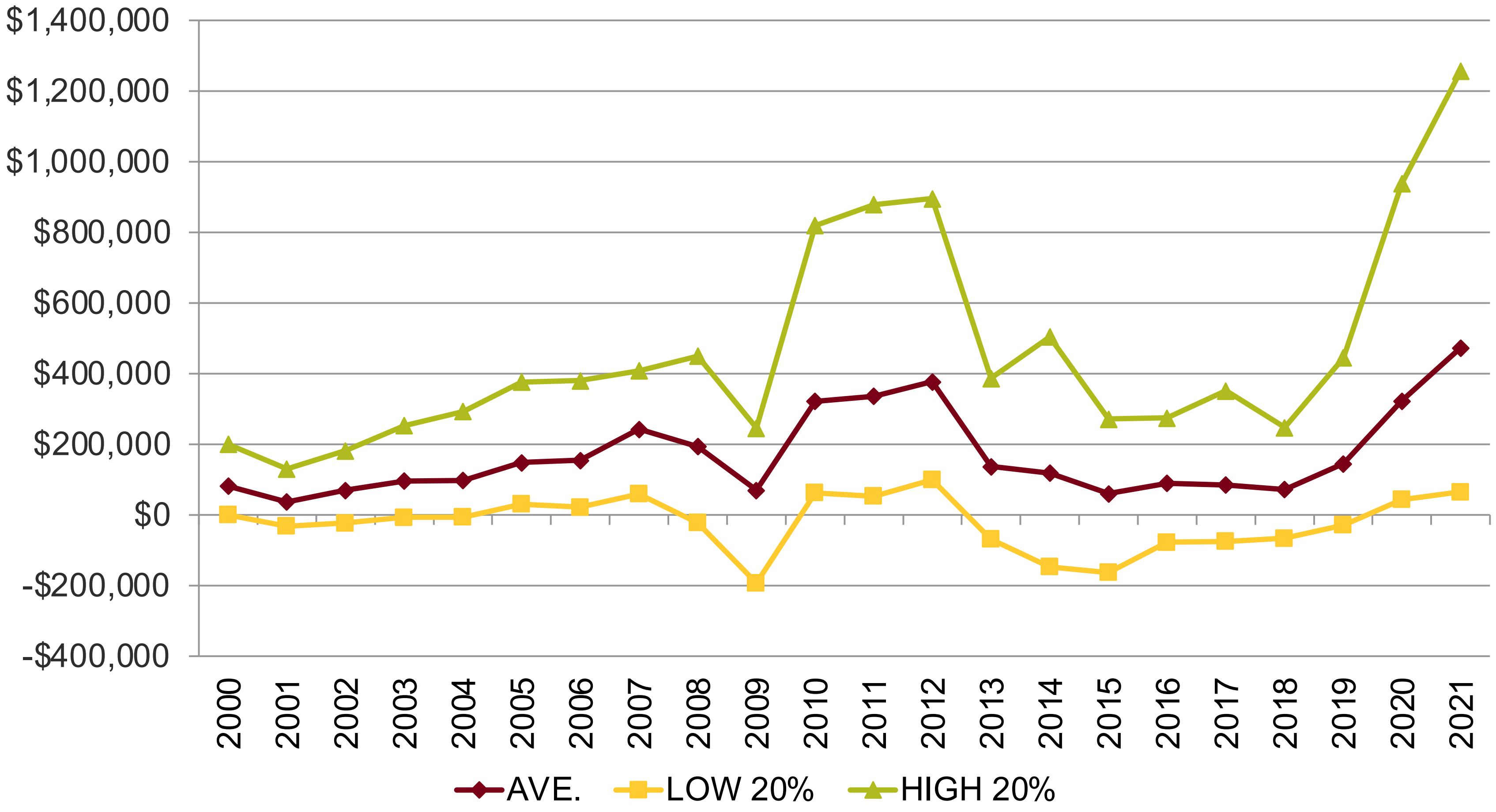
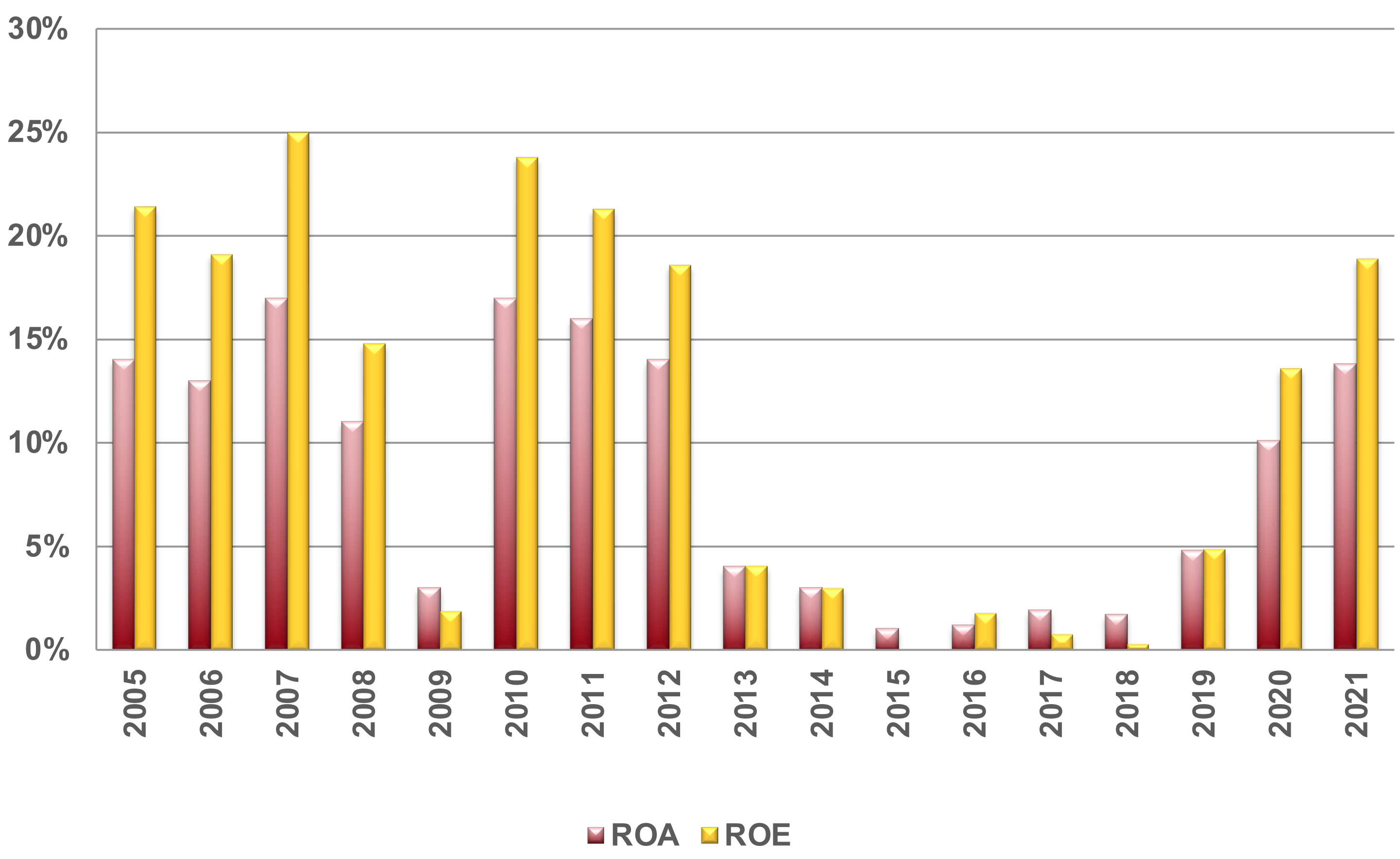
Farm Income & Profitability

- 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

HIGH, AVERAGE, LOW NET FARM INCOME



Profitability - Rate of Return

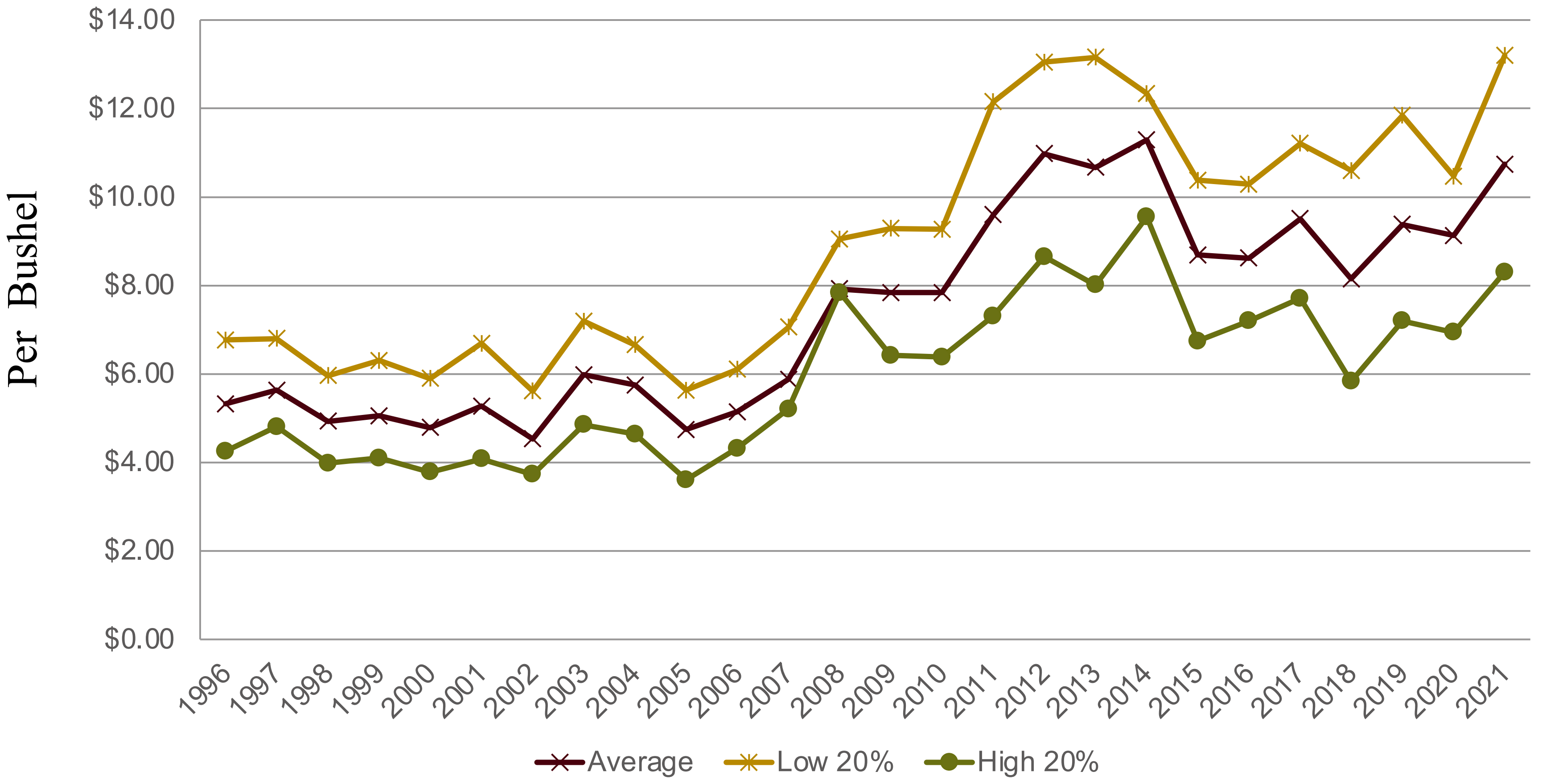


FINANCIAL POSITION - Solvency

- 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

Soybean Cost of Production on Cash Rented Acres



CHAPTER ISSUES

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- 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

P. 75

- 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

P. 76

- 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

P. 77

- $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

Income Item	Tax Return Income	Farm Income
Jane's salary	$40,000	$ 0
Interest income	1,000	0
Capital loss on stock	(3,000)	0
Farm income	50,000	50,000
Gain on sale of breeding livestock	5,000	5,000
Gain on sale of tractor regularly used in the farming business	2,500	2,500
Total	$95,500	$57,500

CROP SHARE LANDLORDS

P. 77

- 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

THE MECHANICS

PP. 77-78

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

OBSERVATION

P. 78

- 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

P. 78

- 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

FIGURE 3.3
Daisy Fields - 2018, 2019, and 2020 Taxable Income

Tax Year	Taxable Income
2018	$28,700 ($10,000 below the beginning of the 22% bracket)
2019	$24,475 ($15,000 below the beginning of the 22% bracket)
2020	$20,125 ($20,000 below the beginning of the 22% bracket)

NO EFFECT ON ACTUAL TAXABLE INCOME

P. 78

- 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

EX. 3.2 DAISY RE-VISITED

P. 79

- 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

P. 79

- 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

TAX PLANNING FOR AVERAGING

P. 80

- 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

PP. 80-81

- 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

RETIRING FARMER

PP. 81-82

- 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

P. 82

- 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

PP. 82-83

- 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

P. 83

- 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

SELF-EMPLOYMENT TAX

P. 83

- 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

ISSUE 2: FARM RENTAL PROPERTY

P. 84

- Terms of rental agreements may have significant tax consequences
- Great variety of arrangements exist
- Legislative changes over the last 10 years warrant review
- Handling tenant improvements to the property
- Personal property rentals – for both asset owner and asset user

CASH LEASE OF REAL PROPERTY

P. 84

- 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-RENTALS AND SE TAX

PP. 84-86

- 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 FARM RENTAL INCOME IS NONFARMING

P. 86

- 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

PASSIVE ACTIVITY LOSS LIMITS

PP. 86-88

- 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

NONDEPRECIABLE REAL PROPERTY

PP. 86-87

- 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

P. 87

- 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

SELF-RENTALS

PP. 87-88

- 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

P. 88

- 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

PRIOR-YEAR PASSIVE LOSSES

P. 88

- 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

NET INVESTMENT INCOME TAX

P. 88

- 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

CASH RENT TENANT TAX REPORTING

PP. 88-89

- 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

CROP SHARE LEASES

PP. 89-92

- 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

PP. 89-90

- 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 Form4835

THIRD PARTY SERVICES

P. 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

PP. 90-92

- 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 ☹

TAX PROVISIONS AVAILABLE TO CROP SHARE LANDLORDS (CONT.)

P. 91

- 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 filing problem regarding Form 7203 and waiver of penalty

OTHER CROP SHARE RENT CONSIDERATIONS

P. 92

- Typical non-materially participating crop share leases:
  - are passive activities
  - are subject to NIIT
- Tenant reports no rent expense, simply has less income

TENANT IMPROVEMENTS

PP. 92-93

- 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

PP. 93-96

- Self-employment Tax
- Passive Activity Limitations
- Net Investment Income Tax
- Is it a Lease or Installment Purchase?

LEASING PERSONAL PROPERTY – SE TAX

PP. 93-94

- 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

LEASING PERSONAL PROPERTY – PASSIVE RULES

P. 94

- 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

7 DAY OR LESS EXCEPTION

P. 94

- 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

PP. 94-95

- 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

NET INVESTMENT INCOME TAX

P. 95

- Rental income is generally subject to NIIT
- Therefore, if taxpayer *regularly and continuously* engages in the equipment rental, the activity would not be passive and NIIT would not apply

LEASE OR PURCHASE

PP. 95-96

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

LEASE OR PURCHASE

PP. 95-96

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 LEASED PROPERTY

P. 96

- 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

QUESTIONS

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