2022 NATIONAL INCOME TAX WORKBOOK

CHAPTER 3: AGRICULTURAL AND NATURAL RESOURCE TAX ISSUES

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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 3: BORROWING AND LENDING TAX ISSUES

PP. 97-104

- Is it debt or equity?
- Imputed interest rules
- Installment sales

DEBT OR EQUITY?

PP. 97-98

- Interest paid is deductible, but dividends are not
- Bad debt deduction or capital loss?

FACTS AND CIRCUMSTANCES

P. 97

- 16 factors – not equal weight and no one factor controls
  2. Relationship between borrower and creditor
  3. Participation in management
  4. Ability to borrow elsewhere
  7. Paperwork
- Page 98 - Ex. 3.23 – Loan to Supplier – conflicting factors

BELOW-MARKET LOANS

I.R.C. §7872 tests interest rates against AFR and imputes interest if insufficient

- Gift loans
- Compensation-related loans
- Corporation-shareholder loans
- Any other loan with significant tax effect
- Loan to qualified continuing care facility w/care contract

APPLICABLE FEDERAL RATE (AFR)

PP. 98-99

- Demand loan must charge AFR
- Term loan must exceed present value (using AFR) of all payments
- AFR published monthly for short-term, mid-term and long-term contracts, by compounding periods
- AFR test applied differently for demand vs. term loans
- Sample rates in Fig. 3.4 and more in "Tax Rates and Useful Tables"

IMPUTED INTEREST

P. 99

- When IRS imputes interest there is a deemed transfer from the lender to the borrower and then an offsetting interest payment
- The impact of the transfer by the lender depends on the structure/relationship:
  - Gift (Ex. 3.24)
  - Dividend
  - Capital contribution
  - Compensation

EXCEPTIONS TO IMPUTED INTEREST

PP. 100-101

- See Temp. Treas. Reg. for list* of exempt loans deemed not to have a significant federal tax impact
- 3 Exceptions included in Sec. 7872
  - De minimis exception for gift loans – up to $10,000 not related to purchase or carrying of income producing asset
  - Compensation and corporation-shareholder loans up to $10,000 unless IRS can show tax avoidance motive
  - Special rule limits imputed gift loan interest to borrower's net investment income – maximum $100,000 loan

CANCELLATION OF DEBT

P. 101

- Borrowed money is not income due to obligation to repay
- When that obligation to repay is cancelled the borrower has an increase in wealth
- General rule is cancelled debt is taxable income
- Several exceptions apply – see 2020 tax workbook

INSTALLMENT SALES (I.R.C. §453)

PP. 101-104

- A sale where at least one payment is received in a tax year after the year of disposition
- Losses cannot be reported on an installment sale
- Nonqualifying gains
  - Dealer disposition including real property except certain timeshare and unimproved residential lots
  - Inventory recorded as such in taxpayer tax records
  - Depreciation recapture income under I.R.C. §1245 or 1250

MECHANICS

PP. 102-104

- Eligible gain is reported on a prorata basis as principal is received
- Gross profit (GP) – gain to be reported on installment sale
- Contract price (CP) – amount of principal to be received by seller*
- Gross profit percentage (GPP) = GP ÷ CP
- Reportable gain = principal received x GPP

ISSUE 5: RETIRING A FARM ASSET

PP. 114-125

- Many reasons to stop using an asset in the business
- Tax implications of
  - Abandonment
  - Donation to charity
  - Conversion to personal use
  - Sale (covered in 2021 tax workbook)

ABANDONMENT

P. 114

- Voluntary and permanent - no ownership/benefit to anyone else
- Deduct remaining ATB as ordinary loss regardless of holding period –Form 4797, Part II. Ex. 3.27

Part II **Ordinary Gains and Losses** (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

Abandoned Shed	2007	2022	0	7,769	10,000	(2,231)

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16.	17	(2,231)

IDLE OR ABANDONED

Ex. 3.27: Note that shed was still depreciable when temporarily idle for 2.5 years but then Form 4797 loss when abandoned

REAL PROPERTY CAN BE ABANDONED

P. 116

Ex. 3.28 Form 4797, Part II loss for abandoned development land

DEMOLITION COSTS

P. 118

- I.R.C. §280B prohibits deduction of demolition costs
- Upon demolition, ATB of building plus demolition costs are added to basis of land
- I.R.C. §280B does not prohibit deducting a loss from abandoning the building
- If a modification of a building does not meet the Rev. Proc. 95-27 definition the cost could be a demolition cost

SPECIFIED RESEARCH OR EXPERIMENTAL EXPENDITURES

P.118

- Any unrecovered cost is not deductible as abandonment
- Taxpayer must continue to amortize
- Note Law Change: could be expensed prior to 2022

ABANDONMENT OF ENCUMBERED PROPERTY

PP. 119-120

- Tax consequences depend on whether debt is recourse or nonrecourse
- Recourse Debt
  - Creditor provides property FMV and outstanding debt amount on Form 1099-A
  - Cross Reference – 2020 tax workbook if recourse debt exceeds foreclosure proceeds and debt is cancelled

ABANDONMENT OF ENCUMBERED PROPERTY

PP. 119-120

Nonrecourse Debt

- Creditor provides property FMV and outstanding debt amount on Form 1099-A
- Abandonment treated as a sale for amount of debt
- Ex. 3.30 Same facts but now Sam reports a sale for $500,000 outstanding loan balance less $350,000 basis equals $150,00 gain – Form 4797, Part III

PERSONAL USE ASSETS

P. 120

- Gains reportable on Sch. D
- Losses are disallowed

- Note year of deduction for abandonment year only

DONATION OF FARM ASSETS

PP. 120-121

- Deduction for property contributions starts at FMV
- Deduction is reduced by
  - the amount of ordinary income or short-term gain if asset had been sold
  - The value of any benefit received by the taxpayer
- *Rolfs v. Commissioner* – no deduction for house contributed to fire department for "training"

CONVERSION TO PERSONAL USE

PP. 121-123

- Generally, no gain or loss at time of conversion
- Any potential depreciation recapture carries over until sold
- Depreciation is prorated in year of conversion based on applicable convention

DEPRECIATION RECAPTURE

PP. 121-122

- Watch out for recapture of "excess" Sec. 179 and "excess" MACRS on listed property both are
  - calculated on Form 4797, Part IV, and
  - reportable on either Sch. C or Sch. F
- Ex. 3.31 Sec. 179 of $27,000 but MACRS would have been only $16,632. Recapture $10,368 (Fig. 3.13)

LISTED PROPERTY

PP. 122-123

- Ex. 3.32 Lightweight Pickup Truck to Personal Use

FIGURE 3.15
Hazel Channing's Section 179 Recapture

Regular MACRS depreciation:		
2020: $13,500 × 20.00%	$2,700	
2021: $13,500 × 32.00%	4,320	
2022: $13,500 × 19.20% × ½	1,296	
Total regular MACRS depreciation		$8,316
Straight-line MACRS depreciation:		
2020: $13,500 × 10%	$1,350	
2021: $13,500 × 20%	2,700	
2022: $13,500 × 20% × ½	1,350	
Total straight-line MACRS depreciation		(5,400)
Recapture amount		$2,916

DEPRECIATION CHANGES DUE TO CHANGE IN USE

PP. 123-125

Change in property use

- is considered placed in service for new use at beginning of year
- does not permit Sec. 179 or bonus
- is not taken into account in determining midquarter convention

CHANGE TO FASTER DEPRECIATION

P. 124

Two choices

- Compute depreciation starting in the year of change using the shorter recovery period and/or faster method
- *Elect* to continue as is (by disregarding the change on that year's timely filed return)

CHANGE TO SLOWER DEPRECIATION

P. 124

- Taxpayer *<u>must</u>* change to the longer recovery period and/or slower method
- Ex. 3.33
  - Farm employer-provided housing (20-year, 150DB) converted to residential rental (27.5-year, SL)
  - Calculate SL depreciation over 18 remaining years of recovery period

SEC. 1245 PROPERTY TO PERSONAL USE

PP. 124-125

- Requires recapture of Sec. 179 in excess of MACRS
- Ex. 3.34 $200k heifer facility becomes personal use
  - MACRS would have been $121,340 (10-year, 150DB)
  - He had expensed the full $200,000
  - Recapture $78,660

Involuntary Conversions

See PDF Handout

INVOLUNTARY CONVERSIONS

Can result from

- Condemnation
- Sale from threat of condemnation
- Weather related sale of livestock
- Casualty

Reporting requires both Form 4684 and Form 4797

CASUALTY

Defined as

1. Damage
2. Destruction
3. Loss of property

Event must be identifiable

1. Sudden
2. Unexpected
3. Unusual

CASUALTY: GAIN OR LOSS

Business property

Gain is taxable unless TP elects to defer and replace the property

Loss is deductible

Personal property

Loss is not deductible unless incurred in a federally declared disaster area (Tax Cuts and Jobs Act modified the rules)

LOSS CALCULATION

Business property loss is smaller of

1. Property's adjusted tax basis, or
2. FMV decrease due to casualty less insurance proceeds or other reimbursements

Loss does not include cleanup, repair, or replacement costs, but these may be used as a measure of the decrease in the property's FMV.

EXAMPLE 1: CASUALTY LOSS OF BUSINESS BUILDING

Sam Stone owned a farm building that was destroyed by fire on April 1, 2018. He paid $245,000

for the building on February 10, 2013, and used straight-line depreciation. The building had a

$225,000 FMV and $196,000 adjusted tax basis just before the fire. Sam received a $155,000

insurance settlement after the fire.

EXAMPLE 1: CASUALTY LOSS OF BUSINESS BUILDING

Adjusted basis of building	$ 196,000
Fair market value (FMV)	225,000
Insurance settlement	155,000

Casualty Loss is $ 41,000 (lesser of adj basis or FMV minus insurance settlement)

Refer to Figure 4.1

EXAMPLE 2: CASUALTY GAIN FROM INSURANCE PROCEEDS

The facts are the same as in Example 1, except that Sam Stone had replacement value insurance and received a $225,000 insurance settlement.

EXAMPLE 2: CASUALTY GAIN FROM INSURANCE PROCEEDS

Adjusted basis of building	$ 196,000
Fair market value (FMV)	225,000
Insurance settlement	225,000

Casualty Loss is $ 29,000 (insurance settlement minus lesser of adj basis or FMV)

Refer to Figures 4.2 and 4.3

ORDINARY INCOME RECAPTURE

On June 3, 2018, Sally Sorta’s bulldozer was destroyed when a building collapsed on it. Sally paid $125,000 for the dozer in 2016 and fully expensed the purchase price under I.R.C. § 179. In 2018, Sally received an insurance settlement for the dozer’s $142,000 current replacement value.

ORDINARY INCOME RECAPTURE

Example 3: § 1245 Recapture in Casualty Gain

Fully expensed bulldozer's cost	$125,000
Insurance reimbursement	$142,000
§ 1245 recapture (Form 4797)	$125,000
Ordinary gain (Form 4684)	$17,000

Refer to Figures 4.4 and 4.5 for Forms 4797 and 4684 reporting

POSTPONEMENT OF GAIN

No gain is recognized or realized if TP receives property similar or related in use or service

Basis in the new property is the adj. basis of the replaced property

To postpone reporting all of the gain, the replacement property's cost must be ≥ to the amount of the reimbursement

REPLACEMENT PERIOD

Generally begins on the day the casualty occurs and ends two years after the close of the first tax year in which any part of gain is realized

If property lost due to eminent domain, a 3-year replacement period applies

Weather related sales of livestock discussed later

REPLACEMENT PROPERTY

Qualifying property must be purchased

Must be similar or related in use or service (more restrictive than like-kind)

More lenient rules apply if destroyed property is located in a presidentially declared disaster area

BASIS OF REPLACEMENT PROPERTY

Replacement property’s cost basis is reduced by the postponed gain

Postponed gain is recognized when the replacement asset is sold or exchanged at a gain

Refer to Example 4.4 and Figure 4.6

Example 4

Sally Sorta, from Example 4.3, can postpone reporting all of her gain if she spends at least $142,000 on replacement business property that is similar in service or use to the destroyed dozer. She must purchase the replacement equipment by December 31, 2020 (the end of the second tax year following 2018, the year the insurance proceeds were received). Her adjusted basis in the replacement property will be reduced by the $142,000 in deferred gain.

Example 4

If Sally buys a replacement dozer for \$185,000, its adjusted basis will be \$43,000 (\$185,000 – \$142,000).

Example 4

On June 3, 2018, taxpayer's bulldozer was destroyed when a building collapsed on it. Taxpayer received insurance proceeds of $142,000. Taxpayer's basis in the bulldozer was $0. Taxpayer hereby elects to defer the $142,000 gain by investing the proceeds in replacement equipment having a cost of $185,000. The basis of the replacement property has been reduced by the deferred gain.

Example 4

Proceeds received	$142,000
Less: adjusted tax basis	0
Gain realized	$142,000
Gain deferred	$142,000
Gain recognized	$0
Cost of replacement equipment	$185,000
Less: deferred gain	142,000
Basis of replacement equipment	$43,000

WEATHER-RELATED PROVISIONS FOR LIVESTOCK SALES

Sales of animals due to weather related conditions

Shortage of feed or water

Draft, dairy, and breeding animals

Not sport or poultry

Postpone gain to avoid bunching of income

Sales in excess of normal practice

TAX TREATMENT

Two different tax treatments for the amount sold in excess of normal

§ 1033(e) applies to sale of draft, dairy, and breeding (not sport) animals that will be replaced within 2 years

§ 451(**g**) applies to sale of any livestock (not poultry or sport) where income is to be deferred to the following tax year

- Code section changed from Code Section 451(e)

REPLACEMENT [§ 1033(E)]

Draft, breeding, or dairy livestock held for any length of time

Sale in excess of normal is involuntary conversion

Gain not recognized if proceeds used to by replacement livestock within the replacement period

REPLACEMENT PERIODS [§ 1033(E)]

Normally have 2 years to purchase replacement livestock

Extended to 4 years if area is eligible for federal assistance

If weather conditions continue for more then 3 years, then replacement period is extended

Refer to IRS Notice 2006-82

REPLACEMENT LIVESTOCK [§ 1033(E)]

Must be of the same use (breeding for breeding or dairy for dairy purposes)

To defer full amount of proceeds, must invest dollar for dollar

Only applies to those animals sold in excess of normal annual sales

§ 1033(E) ELECTION

Evidence that weather condition caused the sale or exchange of animals

Gain computation of the amount realized

Number and kind of livestock sold

Number and kind of livestock that would have been sold under normal business practices

DEFERRAL OF INCOME (§ 451(G))

Cash method farmers

Elect to defer income

Area must be designated as eligible for federal assistance

Prove that excess livestock were sold due to a weather-related condition

§ 451(G) DEFERRAL REQUIREMENTS

P. 128

Taxpayer must meet these requirements

- Principal business must be farming
- Must use cash method of accounting
- Prove that the livestock would normally have been sold in the following year
- The weather-related condition that resulted in a federal assistance declaration caused the animals to be sold

Questions

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