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TAX STRATEGIES FOR U.S. FARMERS: TAX REDUCTION AND AVERTING RISK

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ABSTRACT

This paper presents tax planning strategies specific to farmers. We discuss several opportunities in which a farming operation can either reduce its current tax liability or preserve tax benefits for the future. Under current U.S. tax laws, special provisions exist that are designed to offer the U.S. farmer favorable tax treatment. We specifically highlight these provisions in an effort to remind others of their existence. In addition, there are other provisions within U.S. tax laws that are not so favorable to the U.S. farmer. We provide some suggestions on how the farmer can bypass these rules simply by altering facts and circumstances, which is a lawful behavior. For example, the first strategy we discuss requires the U.S. farmer to plant a secondary crop in order to accelerate cost recovery on an irrigation system. By planting a secondary crop, the farmer has changed the facts and circumstances. Finally, some of the strategies we discuss contain potential risks. We specifically emphasize these risks areas and offer suggestions on how to avoid them.

JEL: G18, G38

KEYWORDS: Tax Planning, Farming, Agriculture, U.S. Tax Laws

INTRODUCTION

We address tax minimization strategies for the U.S. farmers most of which are not widely known. After an extensive search, we found few papers addressing the taxation of U.S. farmers. More specifically, we did not find any papers discussing the special provisions in U.S. tax law applicable to the U.S. farmer. Therefore, we provide specific strategies for the U.S. farmer incorporating these special provisions in an attempt to draw attention to them. We also highlight potential risk areas within certain strategies in which the potential for risk exists. When a potential for risk exists, we offer suggestions on ways to avert that risk.

According to the United States Department of Agriculture (USDA), there are over 2.2 million farms in the United States occupying over 922 million acres with an average farm size of 419 acres. The IRS reports that of these 2.2 million farms, 1.9 million file Schedule F (www.irs.gov/uac/SOI-Tax-Stats---Historical-Table-21) Further, the USDA reports that agriculture and agriculture-related industries contributed $789 billion to the U.S. Gross Domestic Product (GDP) in 2013 making this industry a major part of the U.S. economy (USDA, 2013). Finally, some type of agricultural production occurs in every state in the union; therefore, this industry is not regional or localized, such as oil production, but occurs throughout the United States. Consequently, tax practitioners throughout the U.S. have an opportunity for practice development if farming is not currently an area of practice of a firm.

Several papers have examined tax planning incentives and strategies (e.g. Armstrong, Blouin and Larcker, 2011; Erickson Heitzman and Zhang, 2013). Other papers have examined tax aggressiveness (e.g. Desai and Dharmapala, 2006; Frank, Lynch and Rego, 2009) but these papers examine strategies and incentives under the context of drawing more general conclusions. To the best of our knowledge, no paper has examined tax incentives and strategies related specifically to the U.S. farmer. We provide these strategies through the analysis of the Internal Revenue Code and other tax authority.

In this paper, we analyze the Internal Revenue Code, Treasury Regulations and other IRS guidance (e.g. Revenue Rulings) to offer thirteen strategies in which the U.S farmer can either reduce current tax liability or preserve tax benefits for future use. In our analysis and discussion, we also provide suggestions on avoiding potential pitfalls in the implementation of these strategies. These suggestions include changing facts and circumstances, which is not evading tax. In other words, changing facts and circumstances “after the fact” but merely strategies implemented during the planning stages. The remainder of this paper is organized as follows: Section 2 provides the literature review; Section 3 provides the tax strategies; Section 4 concludes.

LITERATURE REVIEW

Most of the prior tax research in accounting has focused on the financial reporting of U.S. income taxes. Hanlon and Heitzman (2010) provide that this research fall into at least four categories. The first category explores the informational role of a firm’s financially reported tax expense and other tax disclosures; the second category involves tax avoidance; the third category investigates the role taxes has on corporate decision making including capital investment, capital structure and entity choice and the fourth category involves taxes and asset pricing.

We focus on the second category of tax avoidance since we are suggesting tax planning strategies specifically directed at the U.S. farmer in order to avoid tax. The theory behind corporate tax avoidance, whether the avoidance is from a farming corporation or some other corporation, was set within the agency framework model (Slemrod, 2004; Chen and Chu, 2005; and Crocker and Slemrod, 2005). The general theme of these studies is if tax avoidance is a worthy activity then incentive contracts should be structured to ensure that managers make efficient tax decisions. The empirical papers in tax avoidance evaluate measures for tax avoidance, determinants of tax avoidance and the consequences of tax avoidance.

Several tax avoidance papers have developed various proxies for tax avoidance. One of these measures is the GAAP effective tax rate (ETR) or some version of it. GAAP ETR represents the total tax expense per dollar of pre-tax book income. Since the average corporate tax rate is approximately 35%, a lower GAAP ETR will indicate tax avoidance. Some papers have used a variation of ETR such as the Cash ETR (Dyreng et al. 2008) which is used to determine a long run measure of tax avoidance. This measure represents the cash taxes paid per dollar of pre-tax book income. Other papers attempt to measure tax avoidance by using some form of book-tax difference such as discretionary accruals (Desai and Dharmapala, 2006, 2009), the discretionary portion of permanent book-tax difference (Frank et al., 2009). Finally, other papers have measure tax avoidance using a tax shelter proxy (Wilson, 2009) and unrecognized tax benefits (Lisowsky, 2010).

For determinants of tax avoidance, studies have evaluated firm level characteristics association with tax avoidance such as family firms (Chen et al., 2010), international operations (Rego, 2003) and size (Zimmerman, 1983) just to name a few. Other studies examine determinants beyond firm level characteristics and ownership. For example, Robinson et al. (2010) find that when the tax department is considered a profit center, GAAP ETRs are lower whereas Cash ETRs are not. For the consequences to corporate tax avoidance, Hanlon and Slemrod (2009) find a negative market reaction to the information that a firm was involved in a tax shelter whereas Frischmann et al. (2008) find very little market reaction to the passage of FIN 48 and a very small market reaction to a firm’s first disclosure under FIN 48.

The papers discussed above use mostly financial information and not actual tax data from the IRS. Further, the discussed papers only evaluate the existence of tax avoidance using cross-sectional data and try to explain why it is occurring. We present specific strategies for tax avoidance that can be utilized by the U.S. farmer.

TAX STRATEGIES

Tax Strategy #1 – A Cover Crop for Orchard Farmers

The uniform capitalization rules under Section 263A require the inclusion of direct and indirect costs in the basis of property or inventory produced rather than claim these costs as a current deduction. These capitalized costs are recovered through depreciation, amortization or through the cost of goods sold. Generally speaking, farmers are subject to these same rules unless the following conditions and costs exist: (1) the farmer is not organized as a corporation or partnership required to use the accrual method of accounting under Section 447 or a tax shelter prohibited from using the cash method of accounting [Regulation 1.263A-4(a)(2)]; (2) incurred costs of producing animals [Regulation 1.263A-4(a)(2)]; (3) incurred costs of producing plants with a preproductive period of 2 years or less [Regulation 1.263A-4(a)(2)]; and (4) incurred any costs of replanting certain plants lost or damaged due to a casualty [Regulation 1.263A-4(e)(1)].

The issue here is with crops that have a preproductive period of more than two years. The preproduction period begins when the taxpayer first incurs costs that directly benefit the plant and ends when the plants become productive in commercial quantities [Regulation 1.263A-4(b)(2)]. The implication is that farmers whose crops have a preproductive period in excess of two years are not exempt from the uniform capitalization rules concerning those costs. The IRS provides under Notice 2013-18 a list of crops (orchards) with preproductive periods in excess of two years which includes almonds, apples, cherries, plums, etc., just to name a few. Table 1 contains a comprehensive list of crops with a preproductive period in excess of two years. The IRS further provides that preproductive periods are determined using a nationwide weighted average for these crops.

Table 1: Notice 2013 - 18: List of Crops with Preproductive Periods in Excess of Two Years

Almonds	Coffee beans	Kiwifruit	Olives	Plums
Apples	Currants	Kumquats	Oranges	Pomegranates
Apricots	Dates	Lemons	Peaches	Prunes
Avocados	Figs	Limes	Pears	Tangelos
Blueberries	Grapefruit	Macadamia nuts	Pecans	Tangerines
Cherries	Grapes	Mangoes	Persimmons	Tangors
Chestnuts	Guavas	Nectarines	Pistachio nuts	Walnuts

The table provides a comprehensive list of those crops that are not exempt from the Uniform Capitalization rules under Section 263A of the Internal Revenue Code. Section 263A requires all costs incurred associated with a crop prior to the crop's yield be capitalized. Certain crops are excluded from this rule as long as the crop has a pre-productive period equal to or less than two years.

Since farmers whose crops exceed the two-year preproductive period of two years are not exempt from the uniform capitalization rules, the costs of producing the plants such as the cost of seeds, planting, cultivation and maintaining the plant should be capitalized. Additionally, the preproductive costs such as irrigation, pruning, and soil and water conservation should be capitalized [Regulation 1.263A-4(b)].

While these costs must generally be capitalized, the Cover Crop strategy focuses on the cost of the irrigation system and provides potential for an exception. Depending on the size of the crop, irrigation systems can be quite expensive, representing thousands of dollars in cost being capitalized over the preproduction period. To free up the capitalized cost of an irrigation system, consider growing a temporary secondary crop, known as cover cropping, until the preproduction period ends for the primary crop. With orchards, this means growing the cover crop in between the immature trees in the orchard. The irrigation system is then watering the orchard and the temporary cover crop. A cover crop can be any crop with a preproductive period of 2 years or less. For example, Farmer X plants an apple orchard with a preproductive period of in excess of 2 years. Farmer X also plants barley, a cover crop with a preproductive period of 2 years or less, in between the rows of apple trees. Farmer X then installs a micro-sprinkler irrigation system. Since the irrigation system is watering the barley and the barley has a preproductive period of less than 2 years, Farmer X can immediately begin depreciating the irrigation system even though the apple orchard has a preproductive period in excess of two years. Of course, some thought must be given to the type of cover crop since these crops can create problems by making trees more susceptible to frost and by increasing water use. However, when the proper cover crop is selected, these problems are minimized. Some thought must also be given to an irrigation system that can provide water to both types of crops. For example drip irrigation systems might not irrigate both crops unless modifications are done to the system.

Regulation 1.263A-4(d)(2) allows farmers to elect out of the uniform capitalization rules if the farmer is not organized as a corporation, partnership or tax shelter required to use the accrual method of accounting under Section 447 or prohibited from using the cash method under Section 448. In addition, the election does not apply to the costs of planting, cultivation, maintenance, or development of a citrus or almond grove incurred prior to the close of the fourth taxable year beginning with the taxable year in which the trees were planted in the permanent grove.

If this election is made, the plants will be treated as Section 1245 property in which depreciation is recaptured up to the extent of any gain on the sale of the plant [Regulation 1.263A-4(d)(4)(i)]. Additionally, under this election, the farmer would be required to use the alternative depreciation method for predominantly all of the farming property [Regulation 1.263A-4(d)(4)(ii)].

<u>Tax Strategy #2 – Income Averaging</u>

Section 1301 permits an individual engaged in farming or fishing to average their income from farming or fishing (but not income from other sources). The term "individual" under Section 1301 does not include any estate or trust [Section 1301(b)(2)]. In addition, only an individual who is organized as a sole proprietorship engaged in a farming or fishing business, an individual who is a partner in a farming or fishing partnership, or an individual who is a shareholder in a S corporation engaged in a farming or fishing business qualify for income averaging. The partnership or S corporation themselves do not qualify for income averaging [Regulation 1.1301-1(b)(1)(iii)]. Also, services performed in farming or fishing business as an employee are disregarded in determining whether the individual is engaged in the farming or fishing business [Regulation 1.1301-1(b)(1)(iii)].

Essentially, Section 1301 allows an individual engaged in farming or fishing to average elected farm income (EFI) over the previous three years, considered the base years. EFI is the amount of income from an individual's farming or fishing business that the individual elected to tax at the base year tax rates. More specifically, EFI includes items of income, deduction, gain, and loss attributable to an individual's farming or fishing business which could include any net operating loss carryovers or carrybacks or net capital loss carryovers to the election year from the base years [Regulation 1.1301-1(e)(1)].

Electing to income average may reduce your farming or fishing client's current tax burden given that your client's current income from farming or fishing is high relative to the farming or fishing income from the base years. To make this election, you merely need to file Schedule J with your client's Form 1040 for the election year [Regulation 1.1301-1(c)(1)]. However, a farmer is not required to have been engaged in farming or fishing in all of the base years to make the election [Regulation 1.1301-1(e)(1)].To revoke an election, you merely need to file an amended return for the election year within the statute of limitations

[Regulation 1.1301-1(c)(2)]. The instructions to Schedule J (Form 1040) will instruct you how to calculate the amount of tax under income averaging.

It is important to note, if your client's farming or fishing EFI includes both ordinary income and capital gains, your client must use tax rates specific to each separate base year to compute the tax on each type of income. Additionally, the method of income averaging has no effect in the amount of income from employment under the Federal Insurance Contributions Act (FICA) or the Federal Unemployment Tax Act (FUTA) [Regulation 1.1301-1(f)(3)].

<u>Tax Strategy #3 – Hiring Family Members</u>

Have your farming clients consider hiring family members. Your client may deduct a reasonable allowance for wages and other compensation as a business expenses [Section 162(a)(1)]. However, in doing so, your client may lose a dependency exemption if the family member is being claimed as a dependent by your farming client [Section 152 (c) & (d)]. If your client hires family members, who are children, pay close attention to the child labor laws. However, hiring family members can offer certain tax advantages.

Hiring family members, especially children, can allow your farming client to legally shift income from a higher tax rate taxpayer (your client) to a lower rate taxpayer (your client's child) thus reducing the family's overall tax burden. Generally speaking, wages paid to family members are subject to employment taxes but there are exceptions to wages paid to your client's child, spouse or parent. Payments for the services of your client's child in the farming business are not subject to social security or Medicare tax [Section 3121(b)(3)]. Payments for the services of your client's child under the age of 21 employed by your client in any activity other than a trade or business, such as household services, are also not subject to social security or Medicare tax [Section 3121(b)(4)]. It is important to note that if your farming client's child works for the client's farming business in which the farming business is organized as a corporation, partnership or an estate or trust, then the child is subject to employment taxes. The logic is that the child works for the corporation, partnership, estate or trust and not employed by your farming client as an individual. For example, Farmer X hires his 16-year-old son to work in his farming business. Farmer X is organized as a sole proprietorship. Farmer X would not be liable for Farmer X's portion of the social security and Medicare tax on his son's wages and he would not withhold for his son's portion.

Payments made for the services of your client's spouse in the course of the farming business are not subject to the Federal Unemployment Tax Act (FUTA) [Section 3306(c)(5)] but subject to the social security and Medicare tax. Payments made to your client's parents, regardless of the trade or business is also not subject to FUTA [Section 3306(c)(5)] but are subject to the social security and Medicare tax.

<u>Tax Strategy #4 – Backfill Dry Wells</u>

The cost of drilling water wells for irrigation purposes, which include the cost of drilling tests holes, the cost of construction and any other costs of well improvements, are a capital expenditure under Section 265 and cannot be deducted as soil and water conservation expenditures [Regulation 1.175-2(b)]. Therefore, the cost of water wells for irrigation purposes must be recovered through depreciation.

If a water well becomes dry with no chance of future use, have your farming client consider backfilling the well but only if the well will no longer be used. If your client backfills the well before the well has been fully depreciated, your farming client has a loss under Section 165. A loss incurred in a business from the sudden termination of the usefulness of non-fully depreciated property in which the property is permanently discarded from future use shall be allowed as a deduction [Regulation 1.165-2(a)]. Backfilling or sealing a well excavation or casing so that all future economic benefits from the well are terminated constitutes a loss from abandonment.

Tax Strategy #5 – Limit Your Client's Prepaid Expenses

If your farming client is a cash basis taxpayer and has prepaid farm expenses, then those prepaid farm expenses may be limited in amount in the period the payment is made. The general rule is that prepaid farm supplies can only be deducted up to 50% of all Schedule F expenses, excluding prepaid farm supplies. Prepaid farm supplies on hand at year-end due to fire, storm or casualty are not subject to the 50% limit rule [Section 264(c)]. Prepaid farm supplies include amounts paid for feed, seed, fertilizer or other similar farm supplies and not consumed in the year of purchase [Section 464(a)]. In case of poultry farmers, prepaid farm supplies include poultry (including egg-laying hens and chicks) bought for use or resale in the farm business [Section 464(b)]. Any prepaid farm supplies in excess of 50% of all farm expenses (excluding prepaid farm supplies) are considered excess prepaid farm supplies [Section 464(d)(3)(A)] and are deductible in a subsequent period of consumption. For example, Farmer A, a calendar cash basis taxpayer, has $30,000 of prepaid farm supplies on December 31, 2015. Total farm expenses, excluding prepaid farm supplies, was $50,000 for Farmer A in 2015. Farmer A could only deduct $25,000 [50% * $50,000] of the prepaid farm supplies. The remaining $5,000 [$30,000 - $25,000] of prepaid farm supplies would be deductible in a subsequent period in which the supplies are consumed.

The 50% limit does not apply if your client is a qualified farm-related taxpayer [Section 464(d)]. A farm-related taxpayer means any taxpayer (1) whose residence is on a farm, or (2) who has a principal occupation of farming, or (3) who is a family member of a taxpayer described in the previous two conditions [Section 464(d)(2)(B)]. A qualified farm-related taxpayer is a farm-related taxpayer (1) whose aggregate prepaid farm supplies for the preceding three taxable years is less than 50% of the aggregate deductible farming expenses (excluding prepaid farm supplies) for the same preceding three years, or (2) who has excess prepaid farm supplies for the taxable year by reason of any change in business operation directly attributable to extraordinary circumstances [Section 464(d)(2)]. For example, if Farmer Y has $30,000 of aggregate prepaid farming supplies over the preceding three years and $80,000 of aggregate deductible farming expenses (excluding prepaid farm supplies), then the first condition is met.

The goal is to have your client classified as a qualifying farm-related taxpayer thereby allowing your client to deduct all prepaid farm supplies in the current period. Since your client will not continually experience extraordinary circumstances to explain excess prepaid farm supplies (condition #2 for qualifying farm-related taxpayer), your client must avoid excess prepaid farm supplies on an ongoing basis. By doing so, your client can instead use the cash from foregone prepaid farm supplies on short term investments (e.g. money market funds) until the farm supplies are needed.

Special rules exist for prepaid feed for livestock. Your farming client cannot currently deduct the cost of livestock feed consumed in a subsequent period unless all three of the following conditions exist: (1) the payment is for the purchase of feed and not a deposit, (2) the prepayment has a business purpose and was not done for tax avoidance purposes, and (3) deducting the prepayment does not materially distort your client's income [Revenue Ruling 79-229, 1979-2 C.B. 210]. If all three conditions exist, your farming client can deduct the prepaid feed cost but it is still subject to the 50% limitation of Section 464. If not all three of the conditions exist, your farming client can only deduct the prepaid feed expenses in the year the feed is consumed.

Tax Strategy #6 – Excess Farm Losses

If a farming business, except those organized as a C corporation, receives any applicable subsidy for any taxable year, then any excess farm loss for that farming enterprise cannot be deducted for that taxable year [Section 461(j)(1)]. An applicable subsidy means (1) any direct or counter-cyclical payment under Title I of the Food, Conservation, and Energy Act of 2008, or any payment elected to be received in lieu of such payment under Title I, or (2) any Commodity Credit Corporation loan [Section 461(j)(3)].

An excess farm loss is determined by taking the excess of total deductions for the tax year of the farming business, over the total gross income from the tax year from the farming business, plus the greater of: (1) $300,000 ($150,000 for a married taxpayer filing a separate return), or (2) the excess (if any) of the total gross income from the farming business for the prior five years over the total deductions from the farming business for the prior five years [Section 461(j)(4)]. For example, Farmer A (filing married jointly) has total deductions of $1,000,000 and total gross income of $600,000, assuming Farmer A has no farming income or deductions in the previous five years, Farmer A has $100,000 [($600,000 –$1,000,000) + $300,000)] excess farming loss. In other words, if no farming income exists in the previous five years, any loss greater than $300,000 is excess. Another example using the five prior years, Farmer B (filing married jointly) has $1,000,000 of aggregate net income from his farming business in Years 1 through 5. In Year 6, Farmer B has $4,000,000 of gross income and $9,000,000 of farming deductions resulting in a $5,000,000 farming loss in Year 6. Farmer B has $4,000,000 [($4,000,000 – $9,000,000) + $1,000,000)] excess farm loss in Year 6. In this scenario, the $1,000,000 of prior five-year aggregate income is greater than $300,000.

Excess farm losses cannot be deducted in the year incurred but must be carried forward to the next taxable year and cannot be carried back [Section 461(j)(2)]. Farming losses from casualty losses or losses due to disease or drought are disregarded for purposes of determining excess losses [Section 461(j) (4) (D)].

Farming losses, in general, should be avoided if possible, especially excess losses. If the farming family has other income in excess or at least equal to the non-excessive farming loss, then the full farming loss can be deducted. If the non-excessive farming loss exceeds the farming family's other income, then an individual net operating losses (NOL) must be determined by adjusting the loss for other items. For example, the net operating loss must be adjusted for personal and dependent deductions, non-business deductions in excess of non-business income, and capital losses in excess of capital gain, etc. [Regulation 1.172-3(a)]. If the recalculation results in taxable income, no NOL exists and this tax benefit may be lost. Therefore, in order to reduce farming losses, your cash basis farming client should consider accelerating the recognition of income and delay making expenditures. Also, consider electing regular depreciation in lieu of immediate expensing under Section 179 for current acquisitions of farming equipment.

Tax Strategy #7 – Depreciation on Idle Farm Property

Your farming client should continue claiming depreciation on idle farm property. Section 167 allows for a reasonable allowance for wear and tear of property used in a trade, business or for the production of income. Depreciation begins when the asset is placed in service and shall end when the asset is retired from service [Regulation 1.167(a)-10(b)]. Further, "placed in service" means when the asset is first placed in a condition of readiness and availability for a specifically assigned function [Regulation 1.167(a)-11(e)(1)(i)]. Therefore, the asset must only be ready and available for use; the asset is not required to be in continual use. Depreciation would end when the asset is retired from use [Regulation 1.167(a)-10(b)].

For example, a citrus farmer acquires and places into service portable furnaces to keep the citrus fruit warm in periods of frost. The citrus farmer can continue to depreciate these portable furnaces even in a year in which the winter does not produce frost and the furnaces are not used.

Tax Strategy #8 – Losses from Declared Disaster Areas

Of course, this strategy cannot be used on a regular and continual basis like the other strategies. A federally declared disaster by the President must occur in the area of your client's farm. If a disaster is declared, your client may be eligible for federal assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. Special rules apply when deducting losses from federally declared disasters.

Generally speaking, a casualty loss is deducted in the year of the loss; however, if your farming client has a deductible loss in a federally declared disaster, your farming client can elect to deduct the loss in the year immediately preceding the year in which the disaster occurred [Section 165(i)(1)]. This election must be made by the later of the following: (1) the due date (without extensions) for the return for the tax year in which the disaster actually occurred; or (2) the due date (with extensions) for the return of the tax year immediately preceding the disaster year [Regulation 1.165-11(e)]. An election can be made by filing a return, an amended return or a claim for refund clearly showing that the election has been made [Regulation 1.165-11(e)].

If your farming client had sufficient taxable income in the previous tax year, then filing an amended tax return for that year might result in a cash refund. If your client needs cash to recover from the disaster loss, then consider having your client make the election and file an amended return.

<u>Tax Strategy #9 – Estimated Tax Payments</u>

Generally speaking, individuals who are required to pay estimated taxes must pay those taxes in four annual installments. For calendar year individuals, the due dates for these payments are April 15, June 15, September 15, and January 15 of the following taxable year [Section 6654(c)]. In addition, generally speaking, the amount of the required payment shall be 25 percent of the required annual payment [Section 6654(d)]. For calendar year corporations, the due dates are April 15, June 15, September 15 and December 15 with the required payments also equaling 25% of the annual payment [Section 6655(c) and (d)].

However, there are special rules for individuals who are qualified farmers. For those individuals, who are not qualified farmers, the regular estimated tax rules apply. A qualified farmer is an individual whose gross income from farming for the taxable year is at least two-thirds of that individual's total gross income from all sources, or whose gross income from farming shown on the individual's return for the preceding year was at least two-thirds of the total gross income from all sources. Gross income from farming for cash basis farmers includes: (1) the amount of proceeds received from the sale of livestock and produce which was raised, (2) the proceeds from the sale of livestock or other items purchased, (3) amounts received from breeding fees, rent from livestock teams, machinery or land, and other incidental farm income, (4) all subsidy and conservation payments received and (5) gross income from all other sources [Regulation 1.61-4(a)].

Gross income from farming for accrual basis farmers includes: (1) the sales price of all livestock and other products held for sale and sold during the year, (2) the inventory value of livestock and products on hand and not sold at the end of the year, (3) all miscellaneous items of income, such as breeding fees, rent from teams, machinery, or land, or other incidental farm income, (4) any subsidy or conservation payments which must be considered as income, (5) gross income from all other sources, (6) the inventory value of the livestock and products on hand and not sold at the beginning of the year, and (7) the cost of any livestock or products purchased during the year (except livestock held for draft, dairy or breeding purposes, unless included in inventory) [Regulation 1.16-4(b)].

If an individual is a qualified farmer, then only one estimated payment must be made by March 1 of the following year (the first day of the third month after yearend). If it appears that your farming client will not have at least two-thirds of gross income from farming sources and therefore not qualify under the special rule, then have your client consider delaying the recognition of non-farm income if possible. Finally, the IRS may waive the penalty for failure to make the one estimated tax payment on a timely basis. The taxpayer (farmer) will need to show an erroneous Form 1095-A which reported an incorrect amount of the health insurance subsidy and, as a result, the taxpayer missed the deadline to file and pay all tax [Notice 2015-22].

Tax Strategy #10 – Granting Easements

Easements can be granted for many reasons including aviation purposes, beach and landlocked parcel access purposes, utilities purposes, such as electrical lines or water transportation purposes, and conservation involving the limitation of development of the land. Payments for easements can take many forms. The landowner granting the easement can receive a single or multiple payments. Multiple payments can be limited to a certain period or can extend for an indefinite period. Payments can be made for actual land purchases (fee simple sale), for temporary access (rent), for a continuing right-of way (easement), for the diminishment of value (severance), or for the loss or damage to a crop. The tax treatment of these payments depends on the specifics of the easement contract.

A payment(s) for an actual farmland purchase is considered capital income and gain or loss is determined by deducting the allocated basis of the parcel, considered 1231 property, from the sale proceeds [Section 1001(a)]. Generally speaking, payment(s) limiting the right of use for a time specific are considered leases and the lease payments from this type of contract are considered rent taxed as ordinary income [Wineberg v. Commissioner, T.C. Memo 1961-336]. However, lease terms, at least 30 years in duration, are treated as an interest in the real property and are considered like-kind to the real property [Regulation 1.1031(a)-1(c)]

An easement is the right to use real property, owned by another, for a specific purpose. Sometimes easements are granted to prevent the use of real property. Since easements are considered property rights, it is also considered a capital asset and Section 1231 property. Easement payment(s) are first applied to the allocated basis (not to be reduced below zero) of the easement property. If the easement payment(s) exceed the allocated basis of the easement property, then the landowner has recognized gain [Revenue Ruling 68-291, 1968-1 C.B. 351 and Revenue Ruling 77-414, 1977-2 C.B. 299]. For example, Farmer X owns 1,000 acres of farmland, with a tax basis of $1 million. A regional utility company acquires the rights under an easement for the use of 100 acres to run an electrical transmission line. If the utility company makes cumulative easement payments of $125,000, then Farmer X has a $25,000 ($125,000 less $100,000 allocated basis) cumulative capital gain. If multiple payments totaling $125,000 occurred over multiple tax years, then Farmer X would recognize the capital gain according to the rules of Section 453.

If your farming client is prohibited from using the land under easement or if your farming client expects to experience a gain and wants to defer it, consider having your client perform a Section 1031 or Section 1033 transaction. Under certain circumstance, if your farming client is prohibited or is unable to farm the land under easement, then your client can expect to lose farming income. To preserve farming income, it might be in your client's interest to engage in a Section 1031 transaction or to replace seized property under Section 1033 if the property is seized under eminent domain. Several revenue rulings support exchanges under Sections 1031 or 1033 for the exchange of agricultural and scenic conservation easements [Revenue Ruling 69-240, 1969-1 C.B. 199; Revenue Ruling 72-433, 1972-2 C.B. 470; Revenue Ruling 72-549, 1972-2 C.B. 472; Revenue Ruling 76-69, 1976-1 C.B. 219]. Additionally, two private letter rulings support the position that agricultural conservation easements qualify as like-kind with a fee-simple interest in replacement property [PLR 9215049, 1/15/92 and PLR 9232030, 5/12/92].

Tax Strategy #11 – Domestic Production Activities Deduction (DPAD)

Your farming client may qualify for the domestic production activities deduction. To qualify, a taxpayer must have qualified production activities income. Qualified production activities income means the amount equal to the excess (if any) of the taxpayer's domestic production gross receipts for the taxable year over the sum of the cost of goods and other expenses, losses or deductions (excluding the DPAD) attributable to such gross receipts [Section 199 (c)(1)]. Gross receipts means receipts from the sale of qualified production property produced in whole or in significant part within the U.S. [Regulation 1.199-3(g)(1)].

If your farming client qualifies, a deduction is allowed against gross income equal to nine percent of the lesser of: (1) your client's qualified production activities income for the taxable year, or (2) taxable income, for the taxable year [Section 199(a)]. The deduction amount is further limited to 50 percent of the W-2 wages paid [Section 199(b)(1)]. W-2 wages means the sum of the amounts described in paragraphs (3) and (8) of Section 6051(a) paid by your client [Section 199(b)(2)].

Tax Strategy #12 – Business Use of Farming Home

Your farming client may be able to deduct expenses for the business use of the farm home if part of the home is used regularly and exclusively for the administration or management of the farming business and no other fixed location is available to conduct the administration and management activities [Section 280A(c)(1)]. The deductions for the business use of the home are reported on Form 8829 and are limited, in amount, in two ways. The first limitation is based upon the percentage of the home used for business. Home expenses must be allocated to both the business and personal use of the home. The instructions to Form 8829 states the taxpayer "can use square feet or any other reasonable method if it accurately figures the business percentage." The most common method of determining the business use percentage would be to divide the square footage of the business area by the square footage of the entire home. The deductible expenses for the home are limited to that percentage.

For example, Farmer X uses a 200 sq. foot room out of a 2,000 sq. foot home. He incurs the following annual home expenses:

Mortgage Interest	$3,000
Property Taxes	$1,400
Utilities	$800
Property Insurance	$900
Home Security System	$500
Total	$6,600

The business use percentage is 10% [200 square feet ÷ 2,000 square feet]. Farmer X would be able to claim $660 ($6,600 * 10%) of these home expenses. In addition to the $660 amount, Farmer X would also be able to claim depreciation but only on that portion of the home used as a home office.

Expenses for the business use of the home are also limited to the excess of gross income derived from the business less the sum of (1) the deductions related to the business part of the home use even if your client did not use the home for business (e.g. deductible mortgage interest, real estate taxes, etc.) and (2) the farm expenses other than the expenses relating to the business use of the home [Section 280A(c) (5)]. In other words, deductions for the business use of the home cannot take a taxpayer into a business loss. For example, Farmer X has $300,000 gross income from farming, $285,000 of farming expenses not related to the business use of the home and $12,000 of mortgage interest and real estate taxes. Farmer X can only deduct, at most, $3,000 [$300,000 – ($285,000 + $12,000)] of expenses related to the business use of the home.

Tax Strategy #13 – Section 179 Deduction

The Section 179 deduction is a common and popular method for reducing current taxable income. This deduction has been around since the enactment of the Small Business Tax Revision Act of 1958 [P.L. 85-866]. Under the original legislation, the maximum amount for immediate expensing was $10,000; however, the amount has increased over the years. Currently, a taxpayer can immediately expense up to a maximum amount of $500,000 [Section 179(b)(1)] on qualifying property placed in service [Regulation 1.179-4(a)].

There are limitations to the maximum deduction. The first limitation is subject to the total value of all qualifying property placed in service in the same taxable year. Currently, if the taxpayer places into service qualifying property exceeding $2,000,000 [Section 179(b)(2)], the maximum deduction of $500,000 is reduced dollar for dollar on the excess. For example, Farmer X acquires qualifying property, totaling $2,100,000. Farmer X has exceeded the $2,000,000 threshold by $100,000 [$2,100,000 - $2,000,000]; therefore, the maximum Section 179 deduction Farmer X can take is $400,000 [$500,000 - $100,000].

The second limitation is based upon business income. The Section 179 deduction cannot exceed the taxpayer's aggregate amount of taxable income of the taxpayer for such taxable year [Section 179(b)(3)]. In other words, the Section 179 deduction cannot take the taxpayer into a net operating loss (NOL). For example, Farmer Y acquires $900,000 of qualifying assets. He also has farming income of $350,000 before the Section 179 deduction. Farmer Y is not subject to the first limitation because he did not exceed the $2,000,000 of qualifying assets placed in service during the current year; however, Farmer Y is subject to the second limitation of business income. In this situation, Farmer Y's maximum Section 179 deduction is $350,000, the amount of his farming income. Despite this limitation, Farmer Y would be able to carryover the $150,000 [$500,000 - $350,000] disallowed deduction to a subsequent year [Regulation 1.179-3(a)].

There are a couple of additional issues that with the Section 179 deduction. First, only certain types of real property will qualify for this deduction. The real property must be qualified real property which consists of (1) qualified leasehold improvement property described in Section 168 (e)(6), (2) qualified restaurant property described in Section 168(e)(7), and (3) qualified retail improvement property described in Section 168(e)(8) [Section 179(f)(2)]. Additionally, there are special rules regarding sport utility vehicles. The maximum Section 179 deduction on sport utility vehicles cannot exceed $25,000 [Section 179(b)(5)(A)]. The term sport utility vehicle means any 4-wheel vehicle which (1) is primarily designed to carry passengers over public streets, roads or highways, (2) is not subject to Section 280F and (3) is rated at no more than 14,000 pounds gross vehicle weight [Section 179(b)(5)(B)].

CONCLUSION

Tax law has several special rules applying to the farming industry. Some of these rules work in favor of the farmer. Our intention is to remind others of the existence of these favorable laws. For example, qualified farmers are only required to make one estimated tax payment per year if tax is due; whereas, other taxpayers, who are required to make estimated tax payments for tax due, may be required to make four annual installments.

Another intention is to make others aware of tax laws that are not necessarily favorable to farmers. These rules must be taken into account for year-end planning purposes. For example, cash basis farmers may be limited in the amount of prepaid farm supplies they may deduct. Finally, the tax strategies offered in this article are to be applied under the specific facts and circumstances discussed. Each tax strategy must be examined under the facts and circumstances for potential risk areas surrounding the U.S. farmer.

We provide thirteen strategies in which the U.S. farmer can either reduce current tax liability or preserve future tax benefits. These strategies include (but are not limited to) accelerating MACRS depreciation on irrigation systems and other costs associated with the pre-production of certain crops; maximizing the current deduction of prepaid expenses and reducing the number of required estimated tax payments. We also point out potential risk areas associated with these strategies and offer suggestions on ways to avert the risk.

The obvious limitation of this paper is that these strategies are limited in use to the U.S. farmer and most strategies offered are not applicable to other industries. However, use of family members in the business or the Section 179 deduction is among the few strategies that can be used by other U.S. taxpayers. Another limitation is that the strategies offered only apply to the facts and circumstances presented within each strategy; therefore, the U.S. farmer may need to alter the facts and circumstances prior to the implementation of the strategy. In certain cases, changing the facts and circumstances may be impractical or impossible.

Finally, future research can take many directions. One possibility is that more U.S. farmer tax strategies can be offered. U.S. tax law contains other special provisions for the U.S. farmer that were not discussed here. Another possibly is to provide tax strategies for other U.S. industries such as insurance, banking, etc. Still, another possibility is to examine if the strategies discussed here are already being utilized by the U.S. farmer assuming the data becomes available.

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