Farmers ATG - Chapter Three - Basis on Farm Assets

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Introduction

Basis is the amount a property owner can recover as a lump sum when the property is sold, or can charge off as annual deductions through depreciation. The original basis can be changed through capital improvements or by claiming deductions such as depreciation and casualty losses.

Basis equals cost of purchase. This includes all expenses incurred such as freight, installation and other expenses incurred in securing the property and preparing it for service. When land is purchased, basis includes the purchase price plus legal and recording fees, abstract fees, surveys, and payments for permanent improvements.

Basis is determined by how the property was purchased. Property can be purchased, acquired in a trade, received as a gift, or inherited.

Like Kind Exchanges

Basis of property acquired through a like kind exchange is equal to the basis of the property exchanged. When cash is paid in a non-taxable exchange, the basis of the property acquired is the basis of the property traded plus the cash difference paid. An exchange could involve more than one kind of property and basis must be divided among the properties received in the exchange. The basis of any unlike property is its FMV on the date of exchange. The balance of basis is then allocated to the like-kind exchange.

See the new regulations issued under IRC § 1031 for details regarding meeting the like kind requirements, identifying and exchanging property rules.

Gifted Property

To determine the basis of such property consider the following:

1. The original owner's basis in the property before the transfer
2. The FMV of the property when given, and;
3. The amount of tax paid.

The new owner's basis in the property received is usually the smaller of the FMV or the donor's adjusted basis. If tax is paid on the transfer, then a part of that amount is added to the donor's basis in arriving at the new owner's basis (See IRC § 1015(a), Treas. Reg. § 1.1015-1 for additional information.).

Inherited Property

The basis of any property, real or personal, acquired from a decedent is usually its FMV on the date of the decedent's death. If the farm is a joint holding, the surviving spouse is entitled to a stepped-up basis on ½ of such property. If a federal tax return is required and if the property must be included in the decedent's gross estate, the basis is the FMV at the date of death, or, if elected, the alternate valuation date. Under this method, property is valued at the date six months after the decedent's death, if not sold or otherwise disposed (See IRC § 2032 for other information on alternate valuation.).

The basis in inherited property may be figured under the special "farm real property valuation method." IRC § 2032A. This method values the qualified real property at other than its FMV by valuing it on the basis of its use as a farm. If this method is used for estate tax purposes, the value is elected as the basis of the property for the heirs. The qualified heirs should be able to get the value from the executor or personal representative of the estate.

The basis of the property for the qualified heir who receives special-use valuation property is the estate's or trust's basis in that property immediately before distribution. If gain is recognized because of post-death appreciation, the basis is increased by this amount.

Post-death appreciation is the difference between the property's FMV on the date of distribution and the property's FMV on either the date of the farmer's death or the alternative valuation date.

If the farmer makes an irrevocable election and pays the interest on the additional estate tax figured from the date nine months after the decedent's death until the due date for paying the additional estate tax, then the basis in the property is increased to its FMV on the date of the decedent's death or the alternative valuation date. The increase in basis is considered to have occurred immediately before the event that results in additional estate tax. An election is made by filing Form 706 -A with a statement containing: the farmer's name, address, and Taxpayer Identification Number; the estate's name, address and identification number; a statement identifying the election as an election under IRC § 1016(c); and a list specifying the property for which the election is made.

Farm Sale

Selling a farm involves disposing of both business and non-business property. Land, machinery, livestock, and other assets used in farming are business property, while the farm residence is non-business property. For each type of property, the tax treatment is different. Gains and losses may be either capital or ordinary depending upon the asset.

Farmers are eligible to exclude the gain on the sale of the personal residence under the following conditions:

- The farmer (taxpayer) has owned and used the home as his/her personal residence for at least 2 of the last 5 years.

- The farmer has not used the exclusion in the last 2 years.
- The gain on the residence does not exceed $250,000 ($500,000 on a joint tax return). IRC § 121.

A loss on the sale of a farm residence is personal, and therefore, is not deductible. Although not conclusive, provisions in the contract of sale may be evidence as to the value of the residence, particularly if the transaction is between non-related parties. Also note, when the underlying farm land is sold and the principal residence is retained and the house moved to another lot, the gain realized on the land where the house was originally located is not excludable.

Land adjacent to the personal residence and not used in farming is includable as part of the personal residence. The amount of land that can be allocated to the personal residence has been the subject of court cases and should be researched for current guidance.

The sale of unharvested crops with a farm reduces the tax obligation for some farmers, since the crops acquire capital gain status (See IRC § 1231). To qualify for capital treatment the unharvested crops must be sold with the land and meet the following requirements:

1. Land must have been held more than one year and be used in the taxpayer's business of farming.
2. The crop and land must be sold at the same time and to the same person.
3. The seller does not retain a right or option to reacquire the land, unless this right occurs as a part of a security interest in a mortgage.

The crop's stage of maturity does not affect its capital gain status. A crop at any stage, as long as it is unharvested, qualifies.

When unharvested crops are sold with the land and the seller seeks capital gain treatment, the cost of producing the crops must be treated as a capital investment, not as an operating expense. Crop production costs should be added to the basis of the property and excluded from farm operating expenses. Crop production costs include all cash expenses and fixed overhead costs, such as depreciation (IRC § 268).

Remember that if the farmer "elected out" of IRC § 263A on an orchard or vineyard, it is treated as IRC 1245 property. This means that if there is any gain when it is sold, you must recapture the preproductive expenses that would have been capitalized except for the "election". This is when having local cost studies of establishing orchards and/or vineyards is useful to either support the farmer's estimates or to use if records are not available.

Cost Recovery - Depreciation and Depletion

Because farming is a capital intensive industry, a farmer is allowed cost recovery or depreciation on machinery, equipment, and buildings. Depreciation is also allowed on purchased livestock acquired for breeding, draft, and sporting purposes, unless the farmer uses the accrual method of accounting and the livestock is included in inventory. A significant expense on a farm return is depreciation.

The same depreciation rules apply to farming as to any other business. In addition to MACRS, farmers and other taxpayers have three options for depreciating property acquired after 1986 (IRC § 168).

1. Use straight-line method over the regular MACRS recovery period.
2. Use straight-line method over the regular Asset Depreciation System (ADS) midpoint (also known as class life or ADS class life). This method is usually referred to as alternative MACRS.
3. Use 150% declining balance method over the longer ADR midpoint life. This method is available for property other than real property, and is usually referred to as 150% MACRS.

NOTE: Vineyards and orchards are limited to straight-line depreciation.

Farm property placed in service after 1988 is limited to the 150% declining balance on property used in a farming business with less than a MACRS recovery period of 15 years, rather than the 200% available for non-farm property. This change was enacted with TAMRA 88.

There are limits in the depreciation deduction a farmer may claim on listed property placed in service after July 18, 1994. If not used more that 50% in a qualified business, the deduction is denied. If the property was placed in service before 1987, the property must be depreciated using the straight-line method over a longer life. Dollar limitations change yearly (IRC § 280F).

Alternative Minimum Tax (AMT) Adjustment

If the farmer is correctly using the 150% declining balance rate for farm assets placed in service after 1988, there will be an Alternative Minimum Tax (AMT) adjustment. The 150% declining balance method for farm property under normal MACRS rules is calculated using the MACRS recovery period, but under AMT rules, the depreciable life is defined as the alternative MACRS life. Usually, this is a longer time span, and an adjustment will be required in computing AMT.

IRC § 179 Deduction

IRC § 179 is an election that must be made in the tax year that the property is placed in service. The maximum Section 179 deduction for taxable years beginning after 2002 and before 2008 is limited to $100,000 with an adjustment for inflation for any taxable year beginning in a calendar year after 2003 and before 2008. The ceiling is reduced by the excess cost of qualified property placed in service during the year over $400,000, which is subject to the above mentioned adjustment for inflation. Qualified property is tangible, depreciable IRC § 1245 property that is purchased for use in the active conduct of a farm business.

The following properties do not qualify for IRC § 179 deduction:

1. Property acquired by gift or inheritance
2. Property acquired by estates or trusts
3. For property traded in, only the cash paid is deductible as an IRC § 179 expense

4. The property acquired from a spouse, ancestor, lineal descendant, or a controlled entity
5. Trees and vines. See "e" below, per Rev. Rul. 67-51, 1967-1 C.B. 68.

IRC § 179 Recapture

Gains from sales of IRC § 179 assets are treated as IRC § 1245 gains. The amounts expensed are recaptured as ordinary income in the year the asset is sold. The IRC § 179 expense deduction is combined with depreciation allowed to determine the amount of gain reported as ordinary income on Form 4797. This also includes sales on the installment method.

If property placed in service after 1986 is converted to personal use, or if the business usage drops to 50% or less, the IRC § 179 recapture is applicable no matter how long the property was held for business use. The amount recaptured is the excess of the IRC § 179 deduction over the amount that would have been deducted as depreciation.

Special Depreciation Allowance

Farmers are eligible for the special allowance for additional depreciation for certain property acquired after September 10, 2007 and before January 1, 2015. Refer to Pub. 225 (PDF) for the definitions and tests. IRC §168(k).

1245 Property

1. Tangible personal property such as equipment, machinery, tools and trucks (Buildings and structural components **are not included**).
2. Other tangible properties, for example, are:
    - Fences in connection with raising livestock
    - Paved feedlots
    - Water wells that provide water for poultry, livestock, or irrigation of crops
    - Drainage tiles
    - Groves, orchards and vineyards **if productive** (Exempt from IRC §179 per Rev. Rul. 67-51)
    - Bins, gas storage tanks, silos
3. Livestock used for breeding cattle, hogs, sheep, and dairy cattle [purchased, not raised].
4. Single purpose livestock or horticultural structures.

Mineral & Water Rights

Review the schedule of capital assets. If mineral rights, including water rights, are on the schedule, how they were acquired needs to be questioned. Mineral rights can be acquired in various ways. They can be purchased along with the land or they can be bought and sold separately. If purchased as part of the land, review the allocation. If an allocation was made, there should be an appraisal from a geologist. Mineral rights are a capital asset similar to land. A farmer who owns an economic interest in producing mines: oil, gas, or geothermal wells, or any other natural deposits may deduct a reasonable amount for depletion. Economic interest exists if

the farmer has a legal right to receive income from the sale of natural resources. The farmer does not have an economic interest if there is only a right to buy or process the mineral deposits. The depletion deduction can be figured by either the cost method or the percentage method. Water rights are not depletable but may be subject to amortization in limited situations. As long as a farmer continues to be the owner of the land, then a loss cannot be claimed on worthless mineral rights. Any losses when the land is sold are capital losses.

Example

An oil company drills a test well that does not produce on land rented from a farmer. Assuming that the farmer owns the mineral rights, he would only be entitled to a capital loss on the mineral rights when the land is sold, not when the well stops producing. The situation is well described in Louisiana Land & Exploration Co. v. Commissioner, 161 F.2d 842 (5th Cir. 1947).

Cost Depletion

Cost depletion, for water rights, is allowed when it can be demonstrated that the ground water is being depleted and that the rate of recharge is so slow that once extracted, the water is lost to the farmer and to immediately succeeding generations. [See Rev. Rul. 82-214,1982-2 C.B. 115 and Rev. Rul. 65-296, 1965-2 C.B. 181.]

Percentage Depletion

This method may not be used for standing timber, soil, sod, dirt, water, or turf. The percentage depletion deduction cannot be more that 50% of the property's taxable income determined without the depletion deduction and any net operating loss deduction.

For tax years beginning before January 1, 2005, the percentage for oil and gas properties is limited to 100% of the taxable income from the property (computed without the allowance for depletion). For tax years beginning after December 31, 2004, the taxable income is computed without the allowance for depletion and without the deduction under section 199. The 50% limitation still applies to all other depletable properties (IRC § 613). This distinction is important because farmers often have oil and gas interests.

Consider the following when water depletion expense is present:

1. How was the ground water acquisition valued?
2. What is similar land selling for that does not have a good water supply?
3. Has the farmer sold farmland on which water depletion was taken? If so, has the basis of the farmland been adjusted by any cost depletion deductions claimed in prior years.

Commodity Bases

A commodity base is an amount used by the federal government to determine the amount of federal payments a farmer is entitled to receive if he chooses to participate in a federal program

(see Chapter 2, Income). Commodity bases are available for most commodities, such as corn, cotton, wheat, and rice. Over the years the types of programs have varied. As of January 1996, the former payment program which included target prices, deficiency payments and acreage reduction payment programs was replaced with a new program (1996 U.S. Farm Bill) based on flexible production (see Chapter 2, Income). In order to qualify for the old programs, the farmer had to establish a production base in each commodity. This production base is a capital asset attached to the land and no amortization is allowed. If a parcel of land is purchased from a farmer who has established various commodity bases, then a part of the purchase price is allocable to the bases (Rev. Rul. 66-58, 1966-1 C.B. 186). Under the old program, the base amount was adjusted yearly based on yield. A decrease in a base amount does not entitle the farmer to a loss for the decrease [Rev. Rul. 74-306, 1974-2 C.B. 58, explains that a deduction for this kind of a loss is not allowable under IRC § 165(a).]

The 1996 U.S. Farm Bill programs were replaced by the 2002 Farm Security and Rural Investment Act (FSRIA), which provided for three different types of payments for more farm commodities:

- Marketing Assistance Loans: similar to prior program, including Loan Deficiency Pmts (LDP), Marketing Loan Gains (MLGs), Certificate Exchange Gains and Forfeiture Gains.
- Direct Payments: replaced Production Flexibility Contracts (PFC) and Agricultural Market Transition Act (AMTA) payments.
- Counter Cyclical Payments (CCP): new.

Farmers could decide to:

1. Keep their current program base acres, or update their base acres to reflect 1998-2001 cropping patterns.
2. Not update their base acres, and if soybeans are being grown, a soybean base will be created. The farmer can have some other crop base acres shifted into the soybean base.
3. Update base acres and keep old program yields based on 1981-1985 levels or update yields based on 1998-2001 levels.

Program yields cannot be updated unless the base acres are updated. Loan Deficiency Payments or marketing loans have the same rules as in the prior program, but with new average loan rates. They can be taken any time from harvest until May 31 of the following year. Direct Payments are based on the old program yields and the calculated “old” soybean yield, which become fixed once the base acres are determined. Payments for 2002 will be made as soon as possible after December 1; however, the FSA will deduct advance AMTA payments on 2002 crops first. In following years, up to 50 percent will be paid in December prior to the crop year, and the rest in October in the harvest year. Counter Cyclical Payments are made when the national average prices are below the target levels specified in the bill by more than the amount of the direct payment rate. They will be paid up to 35 percent in October of the harvest year (based on projected prices), up to 35 percent in February, and the remainder after September 1.

Basis on Farm Assets - Potential Issues

1. A full year depreciation claimed on assets not held a full year.
2. A full year depreciation claimed on assets purchased at the year end.
3. The most common issue is the allocation of cost to land and improvements. More often than not, an unreasonably low value will be placed on the land. Land is a non-depreciable asset and is not deductible. (See example below)
4. Cultural expenses included in the sale of a farm with unharvested crops must be capitalized in the year of purchase by the buyer. The cost can be deducted in the year that the income from the crops is received. Look at the purchase escrow to see what the purchaser paid for these unharvested crops. Make sure that the right amount was allocated appropriately
   (See Rev. Rul. 85-82, 1985-1 C.B. 57).

Potential Issue – Example

Daniel Boone purchases a ranch for $300,000. The price includes farm equipment, a well and 40 acres of grape vineyards. Since purchase contracts do not show an allocation of assets, Mr. Boone may attempt to assign more cost to depreciable assets. To assess if this has occurred:

A good technique is to request the taxpayer's property tax statement. This will show the ratio between land and improvements. If the statement shows that land is 40% of the total property value, then you know that at least 40% is not depreciable. The remainder should be allocated appropriately among the other assets purchased.

$300,000 × 40% = $120,000 Land

$180,000 Improvements (depreciable amount)

Remember that you can use information from the Department of Agriculture Offices. They have a lot of information that could be helpful.

Information on land values can be obtained by contacting the local state chapter of the American Society of Farm Managers and Rural Appraisers by using their Web site: www.asfmra.org. The California Chapter of the American Society of Farm Managers and Rural Appraisers Web site is: www.calasfmra.com. However, they have the following disclaimer: "remember that the value and lease data presented represents a general range of sales and rental data for each stated market. Specific sales or leases may be higher or lower than the ranges noted. Due to the many factors that characterize agricultural properties in California and Nevada, one should not assume that all of the farms or ranches within a certain area or of a particular crop will fall within the ranges shown." Additional research will be required to accurately estimate the value of specific parcels.