

2023

National Income Tax Workbook

Chapter 12: Agricultural and Natural Resource Tax Issues

PP. 427-476



Issues Covered in this Chapter

P. 427

-
- Issue 1 -- Employee vs. Independent Contractor
 - Issue 2 -- Farm Trade or Business
 - Issue 3 -- Farming S Corporations



Learning Objectives

P. 427

Issue 1:
Employee
vs.
Independent
Contractor
P. 429



U.S. Dept of Labor



Fair Labor Standards Act – 2021 IC
Rule



Economic Reality Test



6-Factor Circumstance Test

Common Law Worker Classification Rules

P. 429

Behavioral
Control

Financial
Control

Relationship
of the parties

Behavioral Control

P. 429

-
- How the work is to proceed:
 - When and where to work
 - What tools or equipment to use
 - What workers to hire or to assist with the work
 - Where to purchase supplies and services
 - What work must be performed by a specified individual
 - What order or sequence to follow when performing the task

Behavioral Control

P. 429

Degree of instruction given to the worker

```
graph TD; A[Degree of instruction given to the worker] --> B[Evaluation system]; B --> C[Worker Training];
```

Evaluation system

Worker Training

Financial Control

P. 430

Significant investment

```
graph TD; A[Significant investment] --> B[Unreimbursed expenses]; B --> C[Opportunity for profit or loss]; C --> D[Services available to the public]; D --> E[Method of payment];
```

Unreimbursed expenses

Opportunity for profit or loss

Services available to the public

Method of payment

Relationship of the Parties

P. 430

-
- Employment Contract
 - Independent Contractor Agreement
 - Payment of benefits, e.g., vacation or sick leave
 - Length of the relationship may indicate the worker is an employee
 - A project-based contract may indicate independent contractor status

Polling Question #1

- Common law worker classification rules look at:
 - Behavioral control
 - Financial control
 - Relationship of the parties
 - All of the above

Economic
Reality
Test

P. 430

Economically Dependent on
employer

In business for oneself

Totality-of-the-circumstances

Opportunity for profit/loss

Investment by the worker

2022

Proposed
Rule &
Economic
Reality Test

P. 430

Investment by the employer

Degree of permanency

Degree of control by employer


Degree of control by the worker

Integral part of business

Skill & initiative

2022
Proposed
Rule
P. 430

The proposed rule was published October 13,
2022,



Replace the 2021 Rule.



Reduce the chance that a worker is
misclassified



Practitioner Note – not finalized

Opportunity
for Profit or
Loss –
Management
Skill P. 431

The ability to negotiate pay

The ability to accept or decline jobs

The right to choose the order or time in which jobs are completed, or hire other employees

Whether the worker engages in marketing, advertising, or other efforts to expand their business or secure more work

Whether the worker makes decisions to hire others, purchase materials and equipment and/or rent space

Example
12.1
Opportunity
for Profit or
Loss P.
431



John is a carpenter in rural Virginia



John began to advertise his services at local farmer's cooperative



Alice saw his add and hired John to build a barn and farm stand. They negotiated the project's price and John completed the work



Alice needs repairs to her house and a fence built; she wants John to do the work



John has other jobs under contract, building a fence would require purchasing tools and hiring employee



John is exercising management skill that affects his profitability - independent contractor

Investments
by the Worker
and the
Employer P.
431

- Is the investment capital or entrepreneurial
 - Tools purchased by a worker to do a specific job are not evidence of capital or entrepreneurial in nature
 - Capital or entrepreneurial investments have a business-like function
 - Compare amounts paid by worker v. employer

Investments
by the
Worker and
the
Employer P.
431

Example 12.2 Nominal Worker Investments

- Jennifer occasionally purchases her own supplies

Example 12.3 Extensive Worker Investments

- Jennifer markets her services to other farms, rents her own office, purchases her computer/tools

Degree of
Permanence
of Work
Relationship
P. 432

Indefinite in duration or continuous



Nonexclusive, project-based, or sporadic (as
needed)



Permanent work relationships may include
regularly occurring fixed periods of work (8-
5), seasonal work, or temporary farming work

Degree of Permanence of Work Relationship

P. 432

Example 12.4 Permanence of the Work Relationship

For 8 months per year, Lucas works for Green Fields Production as specialty crop farm

He has worked for the farm the past 5 years

Lucas provides services to Green Fields exclusively and does not market himself elsewhere, the farm provides tools and equipment plus supervises his work

Lucas is an employee

Nature and Degree of Control

P. 432

-
- Employer's control
 - reserved control
 - performance of the work
 - economic aspects of the working relationship
 - More control by the employer favors employee status
 - More control by the worker favors independent contractor status

Nature and Degree of Control

P. 432



- Who controls

 - prices or rates for services
 - the marketing of the services or products
 - Control of a worker to comply with legal obligations, safety standards, or contractual or customer service standards may indicate that the worker is an employee
- **Practitioner Note:** Safety Training and Drug Testing

Work is an Integral Part of Employer's Bus.

P. 433

The function the worker performs is an integral part.

If the employer could not function without the service performed by the workers, then the service they provide is integral

Employee -- work performed is critical, necessary, or central to the employer's principal business

Contractor -- work performed is not critical, necessary, or central to the employer's principal business

Work is an Integral Part of Employer's Bus. P. 433

Example 12.5 Farm Harvesters Are Integral

Example 12.6 Farm Accountant Is Not Integral



Skill and Initiative

P. 434

-
- Consider whether the worker uses specialized skills to perform the work and whether those skills contribute to business-like initiative. This factor indicates employee status where the worker does not use specialized skills in performing the work or where the worker is dependent on training from the employer to perform the work
 - Where the worker brings specialized skills to the work relationship, it is the worker's use of those specialized skills in connection with business-like initiative that indicates that the worker is an independent contractor

Skill and Initiative

P. 434

- **Example 12.7** Using Skills to Operate Independent Business
 - Gerald is highly skilled as a welder.
 - He provides services to Blue Cow Dairy Farm.
 - He also provides services to other businesses
 - Manages his work schedule
 - Markets his technical skill set
 - Indicative of an independent contractor

Additional Factors

P. 434

Worker is in business for
himself or herself

Employer requires a worker
to obtain a certain license
or adopt a certain form of
business to perform work

Polling Question #2

- The economic reality test looks at whether a worker is _____ an employer.
 - Really nice to
 - Economically dependent on
 - Related to

Worker Classification

P. 435

Fair Labor Standards Act (FLSA) enacted by Congress in 1938

Improve working conditions for employees

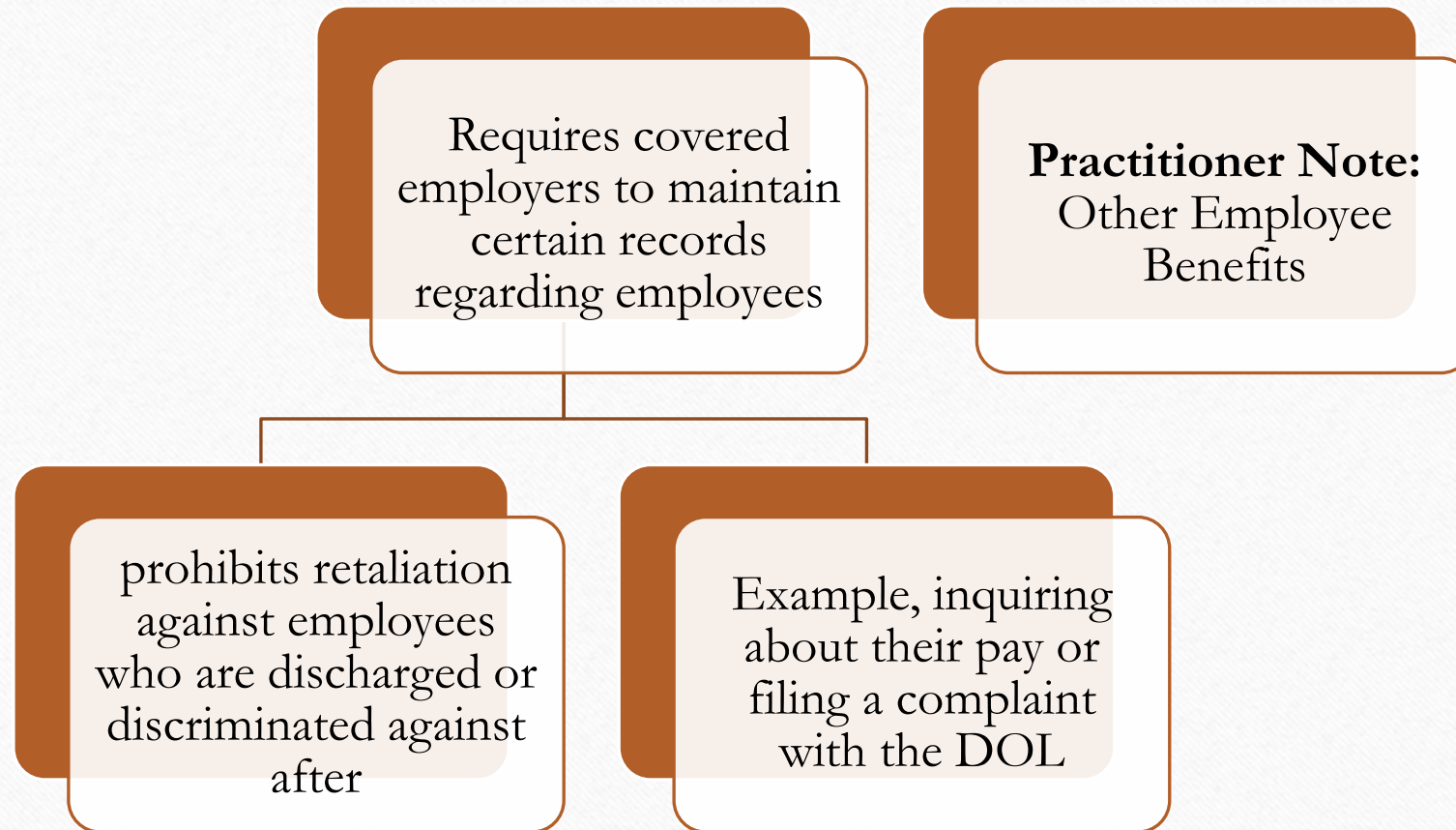
Covered employers to pay nonexempt employees

Pay federal minimum wage

Pay time & a half for every hour worked over 40 in a work week

Worker Classification

P. 435



Income and Employment Tax

P. 435

Employer must withhold FICA and deposit income taxes withholding

Employer must pay the matching employer portion of FICA taxes

Employer must pay FUTA & SUTA

Contractors pay their own

Income and
Employment Tax
P. 435 & 436

Form SS-8 - Employer or Worker can request
a determination based on facts and
circumstances

Section 530 Relief (Practitioner Note: Employment
Tax Examination)

Reporting
Consistency

Substantive
Consistency

Reasonable
Basis

Voluntary Classification Settlement
Program

ISSUE 3:

Farm

Trade or

Business

P. 443

Profit motive

Hobby?

Facts & Circumstances

Regular & Continuous

Conducted for purpose of earning a profit

Sporadic Activity

Start of a Farm Trade or Business

P. 443

-
- **Practitioner Note:** Definition of Farming
 - Treas. Reg. § 1.61-4(d)
 - Treas. Reg. § 1.175-3
 - Other definitions in other contexts
 - *Antonyan v. Commissioner*
 - Business must function as a “going concern”

Startup Expenses

P. 445

-
- **Example 12.10** Beginning of a Farm Trade or Business
 - James acquired property: maple trees, hay fields and 12 acres for cultivation
 - Expenses not deductible currently because the business had not started
 - *Primus v. Commissioner*, T.C. Summary Opinion 2020-2

Startup Expenses

P. 445

- **Practitioner Note**

- I.R.C. § 195: \$5,000 may be deducted in the year business begins, excess ratably amortized over 180 months
- Courts have focused on three factors
 - Whether the taxpayer has profit motive
 - Whether the taxpayer is regularly and actively involved
 - Whether the business actually commenced

Treas. Reg. 1.183-2(b) Hobby Factors

PP. 445-448

The manner in which the taxpayer carries on the activity

The expertise of the taxpayer or his/her advisors

The time and effort expended

The expectation that the assets used appreciate in value

Treas. Reg. 1.183-2(b) Hobby Factors

PP. 445-448

The success of the taxpayer in other similar or dissimilar activities

The taxpayer's history of income or losses

The amount of occasional profit earned

The financial status of the taxpayer

Whether elements of personal pleasure or recreation are involved

Polling Question #3

- A worker that performs one work project with a definitive start and end date typically favors _____ status
 - Independent contractor
 - Employee
 - Head of Household

Manner in
Which the
Taxpayer
Carries on
the Activity
P 446

Complete & accurate books &
records

Business plan

For profit conduct

Improve profitability

Horse breeding & sales

Expertise of
the Taxpayer
& Advisers
P 446

Owner's expertise

Research of activity

Consultation with experts

Advice from experts

Principles & economics of running a
business

Followed advice of experts

Time &
Effort
Devoted to
the Activity
P 446

Devotes much of time

Substantial personal or
recreational aspects

Limited amount of time

Side Hustle

Expectation
Assets
Appreciate in
Value
P 447

Appreciated value

Produce overall profit when sold

Recoup accumulated losses when asset sold

Vague notion – NOT bona fide expectation

Multiple Activities

Farmland Appreciation – Self-Rentals

P 447 & 448

Success of Taxpayer in Carrying on
other or Similar Activities – Alter Ego's

History of Income or Losses with
Respect to the Activity

Amount of Occasional Profits Earned

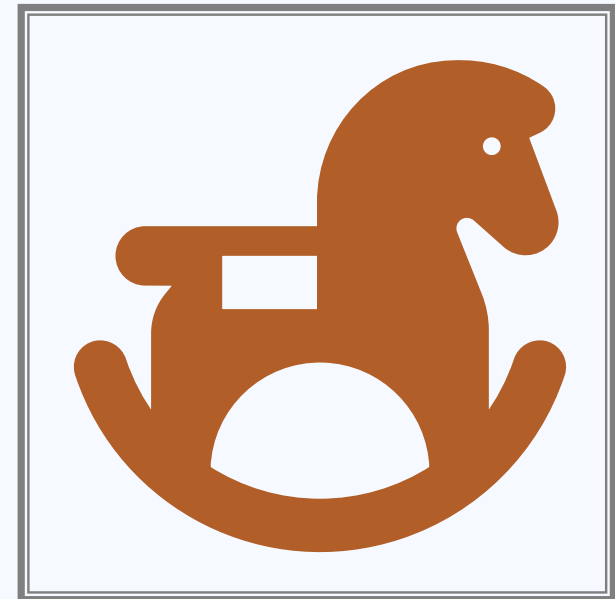
Financial Status of the Taxpayer

Elements of Personal Pleasure

Farm Cases – Horse Racing Hobby Loss

P. 448

- The IRS has historically won these cases -- involve wealthy landowners seeking to offset high income with large losses
- Farming losses are not unusual.
- Expectation of gain = profit motive [Hoyle v. Commissioner, T.C. Memo 1994-592]
- Courts consider maintained
 - business records
 - separate bank accounts
 - sought expert advice
 - obtained little or no recreational benefit
 - changed activities to increase profitability



Farm Case Examples

PP. 448-
449



Example 12.11
Expectation of Future
Farm Profit

W. Clark Wise, T.C.
Memo 1957-83



Example 12.12
Significant Time and
Attention

Walter E. Edge, Jr.,
T.C. Memo 1973-274



Example 12.13 Expert
Advice and Efforts to
Increase Profitability

Leland R. Rosmond, PH
TCMP 51205 (1951)



Example 12.14 No
Business Plan or Separate
Account

Stephen Whatley v.
Commissioner, T.C.
Memo 2021-11

Presumption
that Activity
is for Profit
P. 449

- I.R.C. § 183(d)
- Profit 3 of 5-years
- Profit 2 of 7-year period for activities that primarily involve breeding, showing, training, or racing horses
- Burden of Proof on the IRS
- Electing to Postpone the Determination
 - I.R.C. § 183(e),
 - End of the fourth tax year
 - sixth tax year for horse activities

Making the Election to Postpone

P. 450

-
- Form 5213, Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit
 - **Example 12.15** Hobby Determination
 - Jessica began growing organic vegetables. She deducted expenses for growing the crops and section 179 expensing; her expenses exceeded her income in 2021 and 2022. Jessica sold her produce at a local farmer's market and generated a profit
 - Jessica received a notice of deficiency and immediately filed IRS Form 5213

Example 12.15

Jessica's Form 5213

Form 5213 (Rev. February 2006) Department of the Treasury Internal Revenue Service	Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit ▶ To be filed by individuals, estates, trusts, partnerships, and S corporations.	OMB No. 1545-0195
Name(s) as shown on tax return Jessica Suarez	Identifying number as shown on tax return XXX-XX-XXXX	
Address (number and street, apt. no., rural route) (or P.O. box number if mail is not delivered to street address) 123 Farm to Market Rd.		
City, town or post office, state, and ZIP code Norman, OK 73072		
The taxpayer named above elects to postpone a determination as to whether the presumption applies that the activity described below is engaged in for profit. The determination is postponed until the close of: <ul style="list-style-type: none">• The 6th tax year, for an activity that consists mainly of breeding, training, showing, or racing horses or• The 4th tax year for any other activity, after the tax year in which the taxpayer first engaged in the activity.		
1 Type of taxpayer engaged in the activity (check the box that applies): <input checked="" type="checkbox"/> Individual <input type="checkbox"/> Partnership <input type="checkbox"/> S corporation <input type="checkbox"/> Estate or trust		
2a Description of activity for which you elect to postpone a determination Organic vegetable farming		

Hobby Loss Limitations

P. 451

I.R.C. § 183(b) – non-business activities

Treas. Reg. § 1.183-1(b)(1)(i) -- limited to Gross Income

- Gross Receipts less Adjustments to Gross Receipts (Title 26)

These expenses include mortgage interest [I.R.C. § 163] and real estate taxes [I.R.C. § 164(a)]

Hobby Loss Limitations

P. 451



Practitioner Note: C Corps NOT subject to limitations



Form 1040 Schedule 1, line 8(j)



Prior to 2018, deduct the expenses as miscellaneous itemized deduction subject to the 2%-of-AGI floor



Suspended through 2025

Example 12.16 Applying Hobby Loss Limits P. 452

- Bob and Deborah Lane live on 20 acres in a suburb of New York.
- Bob works for a local security firm.
- Deborah is a data center manager.
- Bob and Deborah earned \$255,000 in W-2 income in 2023
- After attending a seminar about developing a more self-reliant and resilient food networks, Bob and Deborah purchased ten chickens

Example 12.16 Applying Hobby Loss Limits P. 452

- They sold several dozen eggs a month to colleagues at work.
- Bob and Deborah used the remainder of the eggs for personal use.
- In 2023, they bought a tractor and built a barn
 - §179 to expense the cost of their tractor.
 - Begin depreciating the cost of their barn
 - Deduct the expenses of their livestock activities
- Bob and Deborah cannot deduct expenses of an activity that is not engaged in for profit (unless otherwise deductible under another code section)

ISSUE 4: Farming S Corporations

P. 453

-
- 2022 Stats
 - 5,583,837 Forms 1120-S, U.S Income Tax Return for an S corporation filed
 - 4,582,871 Forms 1065, U.S. Return of Partnership Income
 - 2,260,757 Forms 1120, U.S. Corporation Income Tax Return, that were filed

S Corporation Formation

P. 453

- The Internal Revenue Code recognizes
- Partnership [I.R.C. 7701(a)(2)]
- Corporation [I.R.C. § 7701(a)(3)]
- A state law corporation is, by default, a C corporation for federal tax purposes
- **Practitioner Note:** Check-the-Box Regulations
 - Form 8832, Entity Classification Election
 - Form 2553, Election by a Small Business Corporation

Eligible Small Business Corporation

P. 454

Domestic
corporation

No more than
100 shareholders
with Attribution

Shareholder
limited to

It does not have
more than one
class of stock

US citizens

Resident alien
individuals

Certain
Estates/Trust

Eligible Small Business Corporation

P. 454

Practitioner Note: Inadvertent Termination

Example 12.17 IRA Shareholder

- Dealing with an error of transfer of an individual's stock to a self-directed IRA
- Ltr. Rul. 202319003 (January 17, 2023)

One Class of Stock

P. 455

Single class of stock [I.R.C. §
1361(b)(1)(D)].

Applies only to outstanding shares.

Differences in voting rights do not
create multiple classes of stock

Voting and Non-voting common
stock

One Class of Stock

P. 455

Disregard when determining outstanding shares

Buy-sell agreements

Shareholder agreements that
restrict the transfer of stock

Redemption agreements



Practitioner Note: LLC Operating Agreement: possible amendment
needed

Example
12.18 Multiple
Classes of
Stock

P. 456

- Roundup Farms, LLC was created in 2020,
- Elected to be an S corporation
- Operating agreement
 - Liquidating distributions
 - Based on member's capital account balance
- S corporation election terminated on the effective date of its operating agreement

Example

12.18 Multiple Classes of Stock

P. 456

- 2020 and 2021 Forms 1120-S consistent with its election as an S corporation
- It made no disproportionate distributions
- Discovered the error in 2022, before the IRS discovered the provision in its operating agreement
- Immediately amended and restated its operating agreement to remove the terms causing it to have more than one class of stock
- **Cross-Reference:** Rev. Proc. 2022-19, 2022-41 I.R.B. 282 (Business Entity Chapter)

S
Corporation
Election
P.
456



Form 2553, Election by a Small Business Corporation



IRS Service Center (Kansas City or Ogden) where the company files (or will file) its tax returns



File by the 15th day of the 3rd month of the tax year for which the election is to take effect



The entity can file only Form 2553 and does not have to also file Form 8832



Each shareholder who owns shares at the time of filing the S corporation election must consent to the election



There is a simplified method for taxpayers to request relief for late S elections [Rev. Proc. 2013-30, 2013-36 I.R.B. 173].

S Corporation –
Tax Advantages
PP. 456-459

Single Level of Tax

- See two **Cross References**

Self-Employment Tax Savings

- Wages and Self-Employment Income
- S Corporation Dividends
- Reasonable Compensation (Contrast of C Corps and S Corps)

QBI Deduction

- Reasonable compensation

S Corporation –
Tax Disadvantages
P. 460

Gain on Incorporation or Conversion

Distribution of Appreciated Property

Built-in Gains Tax

Net Passive Investment Income

Inherited S Corporation Assets

Partnership
Electing S Status
P 461

- Treas. Reg. 301.7701-3(g)(1)
- All assets contributed in exchange for stock
- Tax-free transaction
- Tax liability
 - §704(c) & §737
 - §751 – disproportionate share
 - §707 – disguised sale

P 461

- Disregarded Entity
 - Treas. Reg. 301.7701-3(g)(1(iv))
 - Contribution – all assets & liabilities
 - In exchange for stock
- Cross Reference: §751 Assets
- Practitioner Note
 - Control Test
 - 80% or more tax free
 - 79% or less taxable event

Gain on
Incorporation or
Conversion
P. 461 & 462

- Assumed Liabilities
 - The deemed contribution of partnership assets and liabilities in exchange for stock is tax-free
 - Debt transferred to the corporation is less than the adjusted basis of the contributed assets
 - Contributing taxpayer's control 80% or more of the stock immediately after the contribution
 - **Practitioner Note:** Promissory Note
 - **Cross-Reference:** S Corporation Basis and Bad Debt

Example 12.19 Assumed Debt Exceeds Basis P. 462

- Alex formed Hogs West, LLC in 2018
- FMV of \$910,000
- Adjusted Basis is \$105,000
- Debt of \$425,000
- In 2023 Alex asks tax pro if converting to an S corp. would reduce tax liability

Example 12.19 Assumed Debt Exceeds Basis P. 463

- Recognize \$320,000 of gain ($\$425,000 - \$105,000$)
- After transfer Alex's basis
 - \$0
 - $105,000$ (adj basis) $- 425,000$ (debt assumed by corp) $+ 325,000$ (gain recognized)

Example 12.19 Assumed Debt Exceeds Basis

P. 463

Asset Description	Adjusted Basis	FMV	Liability
Hog building one	\$100,000	\$300,000	\$200,000
Hog building two	0	250,000	100,000
Hog building three	0	200,000	75,000
Equipment	5,000	150,000	50,000
Miscellaneous tools	0	10,000	0
Total	<u>\$105,000</u>	<u>\$910,000</u>	<u>\$425,000</u>

Practitioner
Note
P 463

- Assumption of Debt
- Agreement between Shareholder and Corp
- Absent an Agreement
 - Non-recourse liability
 - Assumed by transferee

Distribution of Appreciated Property

P.

463

- Gain is not recognized when a partnership distributes appreciated property to a partner
- S corporation with no C corporation
 - Distributes appreciated property
 - Pass through to its shareholders
 - Gain = fair market value

Distribution of
Appreciated
Property
P. 464

- **Example 12.20** Distribution to Shareholders
 - Gerry and Bruce are the only shareholders of J&T Farming, Inc., and S-corp.
 - They want to go their separate ways
 - J&T Inc. recognizes \$315,000 of gain and passes through to the shareholders
 - Gerry got the equipment
 - Bruce got cash
 - Gerry's is treated as having received \$335,000 as Distribution
 - Gerry's basis in the equipment = \$ 335,000
 - Figure 12.4

Distribution
of
Appreciated
Property
P. 464

Cross Reference: Divisive
Reorganizations

One Corporation divided

Separate Business Lines/Divisions

Resolve Disputes

Separate Liabilities for certain aspects of
business

Built-in Gains Tax

P. 465

S corporations that used to be C corporations

Corporate-level tax on gains recognized on the sale of assets

This tax may reduce, or even negate, the benefits of the S election

5-year recognition period

BIG tax is in addition to the tax on the gain passed through to the shareholders on the sale of the corporation's assets by the corporation

Cross-Reference: Built-In Gains Tax

Net Passive Investment Income

P. 465

-
- Accumulated Earnings & Profits from C corporation years
 - Subject to an entity level tax on excess net passive income
 - 25% Gross Receipts
 - Passive Investment Income
 - 3 consecutive years
 - **This is why we don't put rentals in S Corps**

Net Passive Investment Income

P. 465

-
- Calculating the tax at highest corporate rate (21%) on passive investment income:
 - Royalties and rents
 - Dividends and interest
 - Annuities

Net Passive Investment Income

P. 465

-
- Avoiding the Tax
 - Structure rental agreements to provide significant services and be active in the bus.
 - Pay out all earnings and profits to shareholders as a dividend
 - **Example 12.21** Crop Share Rental Agreement

Inherited S
Corporation
Assets
P. 466

- The basis of the deceased partner's interest in the partnership (outside basis) is adjusted to FMV on the date of death (or alternate valuation date)
- No similar provision exists for S corporations.
- Value of the deceased shareholder's stock is adjusted to FMV at date of death
- The Basis of the underlying assets is not adjusted

Inherited S Corporation Assets

P. 466

- To avoid significant tax on the sale of the S corporation assets
- The estate can sell the assets and liquidate the corporation in the same year
- The gain on the sale of the assets increases the basis of the shares
- When the S corporation liquidates, the corporation is treated as having sold all its assets for their FMV.
- The estate is treated as having sold its S corporation shares for an amount equal to the FMV of the assets it receives in the liquidating distribution from the S corporation

Example 12.22 Death of a Shareholder P. 467

- Huckleberry Farms, Inc has one shareholder, August Taylor
- August died August 8, 2023
- Step up basis to FMV based on the underlying assets, \$1,200,000
- None of the heirs want to continue the farm business
- Estate sells the land and equipment and liquidates the corporation in the same year (2024)

Example 12.22 Death of a Shareholder P. 467

- \$900,000 gain on the land
- \$200,000 on equipment
- When the shares are liquidated
 - \$1,100,000 loss which is offset by \$900,000 of LTCG (land)
 - \$200,000 is ordinary income which is offset at \$3,000 subject to the capital loss rules

Example 12.22 Death of a Shareholder

P. 467

Assets	FMV	Adjusted Basis	Gain	Character of Gain
Machinery	\$ 200,000	\$ 0	\$200,000	I.R.C. § 1245
Farmland	1,000,000	100,000	900,000	I.R.C. § 1231
Total	<u>\$1,200,000</u>	<u>\$100,000</u>	<u>\$1,100,000</u>	

Polling Question #4

- _____ allows a worker or employer to request a determination from the IRS regarding a workers classification:
 - A phone call
 - An email
 - Form SS-8

