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## Overview

When a farm is acquired, it is important from a tax standpoint to allocate value to depreciable items and set those items up on the appropriate depreciation schedule beginning with the tax year in which possession is obtained. Of course, land is not depreciable, but when a farm is acquired, there may be items on the land that are depreciable such as fences, drainage tile, buildings, corrals, timber, wells, water lines and residual fertilizer supply. There may be other items (such as a gravel road) that should also have cost allocated to them. How to properly allocate value to these items has become increasingly important in recent months given the increase in farmland values in many parts of the United States, particularly in the Cornbelt. That rise may indicate that greater amounts can be allocated to depreciable items than what has historically been the case. Unfortunately, many purchase contracts or documents associated with gifted or inherited assets do not identify any purchase price allocation for the various assets involved. But, IRS will generally respect whatever agreement the parties to the transaction can agree upon if the parties are not related.

## General Principles

A crucial point is that real estate acquisition allocations must, in every case, be justifiable on audit. So, practitioners must first make sure that sufficient documentation exists to bolster whatever allocated amount is claimed on the tax return. Substantiation is the key. So, what are

the main points when making cost allocations that will survive IRS scrutiny?

The first step is to determine the reasonable fair market value of all of the items associated with the acquisition. Fair market value for such items as roads, tile line and fences should be based on the price that a reasonable buyer and seller would arrive at where neither party is under compulsion to buy or sell and both parties have full knowledge of all of the relevant facts concerning the items in question. For items such as tile lines and fences, that approach will reflect the status of such items at the time of their acquisition rather than what it cost the prior owner to put such items on the property.

The second step is to make the necessary allocations. That may be an allocation of the purchase price for purchased property (based on the percentage of fair market value for each item to the total fair market value times the actual purchase price), or an allocation of the total fair market value of the acquired property if received by gift or inheritance.

The final step is to establish the appropriate depreciation schedules for the various depreciable assets. Fencing is depreciable over seven years, but it's 15 years for tile lines and well/water systems, 10 years for single-purpose agricultural structures and 20 years for machine sheds and farm buildings (that are general purpose farm buildings). Overall, the point of the exercise is to create a tax deduction

attributable to the depreciable items involved in the acquisition.

### **Drainage Tile**

In many parts of the United States, subsurface drainage tile does not exist in farming areas. That may be due to lack of moisture or simply because there is no location to terminate a tile line. But, in many parts of the Cornbelt, drainage tile is common. In these areas, a significant question that has arisen in recent months is how to arrive at the proper depreciable cost of drainage tile on acquired farmland. Just as buyers of other businesses do, persons that acquire farmland traditionally attempt to identify and allocate as much as possible of their cost to assets that will produce a tax benefit through depreciation.

Tiling costs have risen recently along with the rise in farmland values. That has made allocating tax cost to drainage tile difficult in light of the need to stay within guidelines that IRS has issued in the past. Allocations are presently varying widely with some reports of amounts being allocated to tile that exceed actual replacement cost. So, what are the guidelines for determining the appropriate depreciable cost of drainage tile?

**Basic concepts.** As noted above, it is critical to make sure that sufficient documentation exists to bolster whatever allocated amount is claimed on the tax return. That's particularly the case if the allocation to land improvements (such as drainage tile) is high as compared to non-depreciable real estate. A 2006 IRS MSSP Audit Technique Guide (ATG) for Farmers, provided an example of a ranch purchase for \$300,000 which included farm equipment, well and 40 acres of grape vineyards. The purchase price did not show any allocation of assets, and the ATG warned IRS auditors that the buyer may, as a result, try to assign more than the appropriate amount to depreciable assets. To determine if that occurred, the ATG advises IRS examiners to request the buyer's property tax statement. That statement, IRS noted, will show the ratio between land and improvements. IRS points out in the ATG that if the statement

shows that the land is 40 percent of the total property value, then at least 40 percent is not depreciable with the balance to be allocated among the depreciable assets that were purchased. But, that may only be a partial solution, and could still result in too much being allocated to drainage tile even though the total amount allocated to depreciable assets remains within the overall percentage that can be allocated to such assets. In addition, in some states, the statement may only be applicable if there are building improvements on the property.

In a previous IRS training manual for the examination of farm returns, IRS suggested that unless sufficient facts and evidence existed, the depreciable cost of tile for a purchased farm with tile should approximate 5 percent of the cost of the bare land (i.e., the value of the land without tile). But, does that percentage still work in today's agricultural land market? A five percent allocation to tile on land that is worth \$8,000.00 per acre would mean that \$400 is allocated to tile. That seems low given the present replacement cost of tile which has risen dramatically in recent years. So, care must be taken to substantiate any allocation made to depreciable tile. Without such documentation, IRS may argue that the amount to be allocated to drainage tile is not to exceed 5 percent of the cost of the land. For land valued at \$6,000 per acre, that would result in \$300 per acre allocated to drainage tile. That would seem to be lower than what proper documentation would readily support.

### **Establishing the presence of drainage tile.**

The starting point in allocating value to drainage tile is to establish the tile's existence. Tile presents a practical problem in that it cannot readily be seen. So, if possible, tile maps should be acquired from the prior owner along with depreciation schedules. In addition, it may be possible to identify subsurface drainage tile by infrared aerial photographs that are taken within one to two days after a heavy rain. Also, it may be possible to obtain records from local USDA offices that establish the existence and extent of drainage tile. Finally, for some clients, it may be possible to have them hand-draw existing tile lines on a map of the property.

**Establishing replacement cost.** One common approach for determining the amount to be allocated to depreciable tile is to determine the cost of replacing the tile. That would include the cost of the tile itself and the cost of installation. But, along with the recent rise in land values, the price of tile and the installation cost has also risen. One fairly common approach (at least in central Iowa) has been to assign a value of \$2.00 per foot to 8-inch tile, \$1.65 per foot to 6-inch tile and \$1.25 per foot to 4-inch tile. Whether those numbers remain valid is an open question.

Other factors that can impact replacement cost might be the proximity of existing tile lines to the tile main, and whether dredge ditches run through the property. Also, once replacement cost is established, that value will have to be discounted to reflect the character of the tile at the time the property was acquired. Remember, the procedure is to produce a value for tile that would reflect what a willing buyer would deem it to be worth – that’s not the replacement cost of brand new tile for tile that’s five years old, for example. So, while land values and tile cost have risen in recent months, those full increases will not necessarily be reflected in a replacement cost approach that is done accurately. The allocation will be a percentage of new cost, tied to the age of the existing tile on the property.

## **Fences**

A common approach (at least in Iowa) for allocating cost to fencing has been \$1.50 per foot. That tends to work fairly well for fencing that is in good shape, but may be an entirely inaccurate measure for broken-down fencing (which may not warrant any cost allocation).

## **Residual Soil Fertility**

Upon acquisition of farmland, it may be possible for the new owner to claim expense deductions for above average residual soil fertility (so long as the party acquiring the property had not farmed the property during the prior crop year). In essence, the tax law allows the new owner to account for the carryover (i.e., “residual”)

fertilization in the soil that is present at the time of the transfer. That makes sense because, at least for purchased farmland, a willing buyer would pay more for well-fertilized land. Taxpayers that are engaged in farming can make an election to expense, on an annual basis, the cost of soil conditioners (such as fertilizer, lime or potash). The election is made by deducting the expense on the return. If not expensed, the costs must be capitalized and the costs recovered over the useful life of the conditioners (probably 3-5 years) by an operating farmer, crop-share or cash-rent landlord.

Presently, excess soil fertility rates are ranging from \$50 to \$300 per acre in north-central Iowa.

**Measurements and valuation.** The key issue is how to measure the extent of and determine the value of such excess fertilizer supply. Fortunately, grid soil samples can be utilized to assist in measuring soil fertility. Likewise, agronomists have established guidelines for determining average (base) soil fertility for various soil types. The grid soil samples can be compared to base fertility on comparable soil types to establish the amount of “excess” fertility (if any) on any particular tract of farmland. If possible, soil sampling should be completed no later than the time the party acquiring the property takes possession. If that can’t be done, soil samples will have to be taken before any additional fertilizer is applied by or on behalf of the person acquiring the property.

**Documentation.** Most likely, any purchase contract involving the farmland will not document existing soil fertility. In that case, the person acquiring the property will need an expert opinion (such as from a professional agronomist) summarizing the extent of soil fertility, that it is above average when compared to comparable land and the timeframe over which the additional amount of soil fertility would diminish due to crop production. That documentation is necessary in the event of audit – the taxpayer must establish the extent and period of effectiveness of the residual soil fertility.

## **Conclusion**

When farmland is acquired (whether by purchase, gift or inheritance) it is important to allocate value to depreciable items. Being careful to properly allocate such value and maintain documentation of how such allocations were arrived at can convert a portion of the purchase price (or value of the transferred land) into valuable tax deductions. Of course, it's always best if the parties to the transaction can agree on the allocations. For purchased farmland, the portion of the purchase price that is allocated to depreciable items such as fences, tile and residual fertilizer supply can trigger ordinary income to the seller at a 35 percent rate. IRS monitors inconsistent allocations on the returns of the buyer and seller by assessing the buyer based on the seller's return and vice versa. So consistent tax reporting is a must.

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