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I. COMMON QUESTIONS AND ANSWERS

Q1: Should a small cash wage be paid to employees receiving commodity wages to receive disability benefits from Social Security?

A1: Yes. The IRS guidelines state that the taxpayer needs to have some cash wages for ongoing living expenses. In other words, the IRS doesn't believe that it is right for a person to have 100% commodity wages. There is no authority for this position, however.

Also, the return on investment for Social Security earnings is quite good on the first tier of benefits. The first tier benefits are based upon monthly indexed earnings of up to about \$9,500 at the 90% level. That is, if a person targeted average monthly indexed earnings at \$9,500, the monthly full benefit is \$712.50 (\$9,500 times 90% divided by 12). It is also possible to build-up disability coverage very quickly and to earn quarters toward full coverage. That's another point to keep in mind.

Q2: Is equipment rent to an S corporation/corporation owner personal property rent subject to self-employment tax?

A2: Not if the rent is yearly. That is, if the individual leases equipment to the corporation (or partnership) for a fixed amount and the entity is responsible for repairs with normal wear and tear allowed, the individual is not "in the business" under the *Groetzinger* test. In a recent case, a taxpayer (S corporation shareholder) had portable signs and the IRS found that he was subject to SE tax because he was moving the signs around and had other services to perform. So, if the individual leases the equipment on a "per machine hour" or "engine-hour" basis, self-employment tax will result. Of course, an additional point is that personal property leased with real estate is statutorily excluded from self-employment tax.

Q3: Should farm operations be kept in a C corporation if the FSA payment limit decreases with the next Farm Bill?

A3: If the individual lives on the farm, and they can keep farm income below the \$75,000 level (preferably below \$50,000) and move all remaining income to the individual through rents and compensation, the C corporation provides a great tax-free benefit under I.R.C. 119 for meals and lodging furnished to employees for the convenience of the employer that probably should be maintained. Additional tax benefits can be obtained if the corporation also owns the house. Also, for the higher income farmer, the income kept in the corporation will also escape (at least

for now) the net investment income tax (effective January 1, 2013). One other consideration is that the C corporation tax is fully deductible. It would be better in states where the corporate tax is less than the individual tax.

Q4: How should I handle the situation where a person retires early, draws a commodity wage, and then has their retirement benefits withheld for earning too much in a year. Should I simply tell people to write a letter to SSA explaining that the income is not part of earnings during the early retirement period?

A4: I wouldn't think that the Social Security Administration (SSA) would bill them for it. The earnings are not showing up in Box 3 or 5 of the W-2. Drafting a letter should work if for some reason the SSA thinks otherwise.

Q5: Can a limited partner in an family limited partnership (FLP) take an I.R.C. §179 deduction without having any self-employment income? The limited partner does file a Schedule F and the FLP rents equipment from a related entity that is owned in part by the limited partner.

A5: If the question is whether the limited partner has to have self-employment income to be able to claim I.R.C. §179, the answer is that they don't have to have self-employment income because I.R.C. § 1245/1231 gain from the trade or business will also count as "active trade or business income" for purposes of I.R.C. §179. Pass-through income from an S corporation can be active trade or business income. So, self-employment income is not a requirement. The "active" requirement for purposes of I.R.C. §179 is a rather low threshold. But, if the only business income of the individual is as a limited partner and also as rental income which didn't rise to the level of a trade or business for self-employment tax purposes, that could make I.R.C. §179 unavailable in the eyes of the IRS. I.R.C. §179 should still be available because there is trade or business income, and "active" doesn't require much.

Q6: If a C corporation furnishes housing to employees of a grain operation, how can the arrangement best be established to survive IRS scrutiny?

A6: To satisfy the IRS, the housing on-site must be required as a condition of employment for the convenience of the employer. Some IRS offices in the Dakotas are taking the position that such arrangements are a scam. However, there are cases that demonstrate that taxpayers can succeed even if the farming operation is a non-livestock grain farm.

Make sure to document that the farm is remote and a physical presence is needed. The physical presence doesn't have to be 24 hours a day. One reason for a physical presence on site that has gained significance in recent years is to decrease problems with theft and vandalism of expensive equipment and shop supplies. Also, if grain is stored, the grain probably has air fans and systems that need monitoring to maintain proper moisture levels.

Q7: What issues are involved when a C corporation builds a house (leasehold improvement) for the owner/employee on the owner's personally held land. Problems? Rules to abide by? What happens when the lease is over?

A7: The preferred approach would be a ground lease for at least 20 years, with the corporation building the house. The house can be depreciated over 20 years. I.R.C. §109 passes the house out to the landlord tax-free at the expiration of the lease. Under that provision, gross income does not include income (other than rent) derived by a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee.

If improvements are to be made to the house, the best practice is to extend the lease, otherwise it really wouldn't make much sense for the corporation to incur additional costs if there are only a few years remaining on the lease. The corporation needs to get its money's worth from the improvements.

Likewise, if the existing house is leased to the corporation, and improvements are desired, the house should be leased for a long enough number of years to justify the corporation spending the money to make the improvements. The corporation can depreciate the improvements.

Q8: Should semis be placed in an LLC, or should there simply be more insurance coverage.

A8: This seems to be primarily a liability issue. Perhaps the structure could be a single-member LLC under the corporation. But, in some states, the equipment should be in the corporation to avoid state sales tax on the equipment lease. There are a few states that subject agricultural equipment to sales and use tax.

Q9: What is the beginning of the holding period for gifted commodities? Is there any way to use the plant date rather than harvest date to get the clock started sooner?

A9: The harvest date starts the holding period for gifted commodities. As of the date of planting, there is a different asset involved – there is no commodity yet. There isn't any grain until it is harvested.

Similarly, when a C corporation makes an S election after the crops are planted but before harvest, the C corporation arguably has a different asset than the asset that the S corporation sells. The grain was not an asset held by the S corporation at the S election date. The growing crop is not the same asset as the resulting grain. This is an extension of an IRS Technical Advice Memo. In that TAM, the IRS held that growing timber was not the same as the logs from the harvest of the timber. The sale of the logs did not generate BIG.

Q10: Can farm income averaging be used if the result of using it actually *increases* tax liability, but spreads income out more evenly over the current and prior years?

A10: There is no requirement restricting the use of income averaging via Schedule J only if the income averaging electing saves tax. It can be used when there is no change in tax. But, the IRS will probably send a notice, however, saying it has recomputed the tax. The IRS error rate on notices relating to Schedule J is very high, usually resulting in the IRS giving money back that it shouldn't.

Q11: How do you manage the 3.8% tax where the taxpayer owns the land personally and rents it to their active farm corporation. With I.R.C. §179 not available in rental situations, apparently some are having the corporation buy the equipment and then utilize I.R.C. §179 and bonus depreciation. With the increase in land rents, however, this tends to create a pile-up of income on the taxpayer's 1040 that is subject to the 3.8% tax. Is there a better way to structure this?

A11: Probably not. It usually is not a good idea to put farmland in a C corporation, so that's not a viable option. If the farmer makes too much money, can't defer any more, can't prepay any more, can't spread the income to more family members in some manner, they may just have to pay the tax.

A split-interest purchase of land could be an option. Let the corporation purchase a 30-year interest in newly purchased land, with the next generation having the remainder interest. This technique tends to work much better in times of higher interest rates where the younger generation needs some funds to pay for its portion of the purchase price.

II. AFFORDABLE CARE LEGISLATION – CHECKSHEET FOR SMALL BUSINESSES

The employer mandate. Effective for months beginning after 2013, the legislation mandates that companies with 50 or more “full-time” employees provide “acceptable” health coverage or pay a penalty tax (termed a “shared responsibility payment”). The penalty tax is non-deductible and is the lesser of \$2,000 tax per employee beyond the first 30 full-time employees (or their equivalent) or \$3,000 for employees that get insurance through a health insurance exchange and receive a subsidy.

Under the provision, a “full-time” employee is defined as any employee averaging more than 30 hours of work per week.

Note: Because there is no penalty tax applied to businesses that don't provide health insurance to part-time employees, the provision creates an incentive for businesses to hire part-time employees rather than full-time employees.

“Acceptable” health coverage must be “affordable” and satisfy various minimum value requirements. For example, a plan must cover at least 60 percent of the total cost of covered services, and an employee's share of the premium cost on an annual basis cannot exceed 9.5 percent of the employee's annual household income for self-only coverage.

Note: How employers legally obtain household income information remains unknown. But, the Treasury expects to prepare a safe number that would determine affordability of an employer's coverage by referring to an employee's wages from the employer reported in Box 1 of Form W-2. *IRS Notice 2011-73*.

A plan that meets the minimum requirements means that the company's employees are not eligible for any federal subsidies to buy government health insurance.

The employer mandate is enforced by requiring businesses to submit additional information to the IRS via the businesses' tax return. The return must include the names of each full-time employee and pertinent information about the health insurance plans offered.

Note: While the statute says that the provision is effective for months beginning after 2013, the President, in late summer 2013, unilaterally delayed enforcement of the employer mandate until January 1, 2015.

Small business insurance tax credit. The Act (effective for amounts paid or incurred after Dec. 31, 2009) creates a tax credit (as a general business credit) for businesses with 25 or fewer full-time equivalent employees (determined by taking total paid employee hours (excluding owners, partners, family members and seasonal workers employed 120 days or less) for hours worked that don't exceed 2,080 hours during the year, divided by 2,080) and average annual wages of less than \$50,000. *I.R.C. §45R*. To be eligible for the credit, the employer must offer health insurance to its employees (but not an employee's dependents) and pay at least one-half of employees' premiums. The maximum credit is 50 percent of non-elective contributions that a qualified business makes for employees for insurance premiums for years 2014 and 2015 (35 percent for non-profit employers). The credit is capped at 35 percent for years 2010-2013. Any premium that is paid in accordance with a salary reduction arrangement under an I.R.C. §125 cafeteria plan is not treated as paid by the employer.

Note: Beginning in 2014, the credit is only available for insurance coverage obtained through a government "exchange" (Small Business Health Options Program (SHOP)). Also, beginning in 2014, the SHOP is available only to businesses with less than 50 "full-time" employees. Beginning in 2016, the SHOP will be available to businesses with less than 100 "full-time" employees.

While there is no requirement mandating businesses to buy insurance via the SHOP, the tax credit is only available to offset the cost of purchasing insurance via the SHOP.

Grandfathering. Businesses may be eligible for grandfathering of existing health insurance plans. A grandfathered group plan must have been in place before March 23, 2010 (the effective date of the Act). Such a plan need not meet the same requirements as SHOP plans. For instance, grandfathered plans need not offer "essential health benefits" or cover free preventative care. In addition, a grandfathered plan can remain in place if an employer enrolls additional employees. As long as significant changes are not made to the group plan, the employer's plan remains grandfathered.

Employee notification. As of October 1, 2013, employers were required to notify employees of the government health care "exchange." The required notice informs employees of their eligibility for government health insurance, and notifies the employee that if the employee buys government insurance they could forfeit any contributions that the employer makes to their health care coverage. The U.S. Department of Labor has provided a sample notification.

Employers must also provide employees with a “Summary of Benefits and Coverage” form. The form is to detail the cost of an employee’s health care and the coverage provided. The Small Business Administration maintains that an employer is subject to a penalty if a summary is not offered, but the failure to not send employees the notice mentioned above does not subject the employer to a penalty.

III. AFFORDABLE CARE LEGISLATION – MEDICAL REIMBURSEMENT PLANS

Effective January 1, 2014, the Act bars health plans with an annual dollar limit on essential benefits. So, whether a medical reimbursement plan is allowed under the Act depends on whether the plan is “integrated” or “stand-alone.” An integrated plan (one that is integrated with other coverage as part of a group health plan) does not violate the Act’s annual dollar-limit rules if the group health plan with which it is integrated is in compliance with the Act. That means that the employee must also be enrolled in the primary group health plan coverage. Thus, stand-alone reimbursement plans are not a permissible type of coverage beginning in 2014.

The Act did not extend I.R.C. §105(h) discrimination rules to all plans. Under I.R.C. §105(h), an “insured” plan can be offered to a select class of employees. If it is a self-insured plan, it cannot discriminate in favor of highly compensated employees. Those rules continue to apply. But, under the Act, the discrimination rules are extended to plans that are subject to §2716 of the Public Health Service Act, but not to insured group health plans that are considered to be “excepted benefits” under state insurance department rules. In addition, the Department of Labor has issued safe harbor guidelines to aid in determining whether a plan is a supplement excepted benefit. Under the safe harbor, the supplemental plan must be issued by an entity separate from the one issuing the primary plan, it must be designed to fill gaps in the primary coverage, cannot use health factors to differentiate between individuals in terms of benefits, eligibility or premiums, and must not exceed 15 percent of the primary coverage cost.

Part II. D. 1 of I.R.S. Notice 2013-54 specifies that the “market reforms” of the Act do not apply to a plan that has fewer than two participants that are current employees. That provision is codified at I.R.C. §9831(a)(2). Such plans are exempt from the overall and preventative services no-cap rule. Thus, a Schedule F sole proprietor that employs the proprietor’s spouse would still qualify for an I.R.C. §105 plan, even if the plan allowed the employee-spouse to seek reimbursement for family health care expenditures. I.R.C. §105 plans are also still permitted for ancillary benefits such as dental and vision coverage, long-term care and disability. Thus, an employer with more than one employee can still get pre-tax dollars over to the employees in a manner that is exempt to them for such costs. However, the stand-alone I.R.C. §105 plan for one employee would clearly prevent that employee from accessing the exchange subsidy or the I.R.C. §36B credit.

New “Fee” on Medical Reimbursement Plans

The Act also imposes a fee impacting plan years that end between 2012 and 2019. The fee is set forth in I.R.C. §4376 and applies to any applicable self-insured health plan for each plan year ending after September 30, 2012. The fee is \$1 per average number of lives covered under the

plan for plans that end during fiscal year 2013. It is \$2 thereafter. The fee is to be paid by the “plan sponsor” which is defined as the employer for plans established or maintained by a single employer. An “applicable self-insured plan” is any plan for providing accident or health coverage if any portion of the coverage is provided other than through an insurance policy and is established or maintained by 1 or more employers for the benefit of their employees. It is an excise tax remitted via Form 720. The first payment was due July 31, 2013, for calendar year 2012. In essence, payment is due seven months after the plan year end. The fee has a sunset provision – it doesn’t apply to plan years ending after September 30, 2019.

The penalty for failure to file Form 720 and pay the fee appears to be the penalty imposed by I.R.C. §6651. Under that provision, the penalty can be up to 25 percent of the tax due, but “small employers” pay a penalty of the lesser of \$135 or 100 percent of the tax due. Thus, for a married couple with two kids, the tax would be \$4. If the \$4 tax weren’t paid, the failure to pay would result in a \$4 penalty in addition to the requirement to pay the tax.

Note: The IRS has said that the tax is a “fee” that the employer can deduct as an expense of doing business.

IV. FINAL REPAIR REGULATIONS

Overview

In mid-September of 2013, the Treasury and the IRS issued final and proposed tangible asset and repair regulations. *TD 9636*. These are a follow-up to the temporary and proposed regulations issued on December 23, 2011, that were ultimately effective for tax years beginning on or after January 1, 2014. *TD 9564*. While most of the regulations are final, the proposed regulations relate to the disposition of tangible property. In general, the final regulations with respect to materials and supplies and the de minimis safe harbors are more taxpayer friendly than were the proposed regulations, and provide a framework for determining whether costs incurred for materials and supplies, repairs and maintenance (and other tangible asset costs) can be currently deducted or must be capitalized.

Materials and Supplies

Under the final regulations, the definition of “materials and supplies” includes items that cost \$200 or less (up from \$100 under the proposed regulations). Also included in the definition are emergency spare parts. Treas. Reg. §1.162-3(c)(3). Qualified property is tangible property that is used or consumed in the taxpayer’s business that is not inventory held for sale and that:

- Is a component acquired to maintain, repair or improve a unit of tangible property that the taxpayer owns, leases or services and is not acquired as part of any single unit of property including rotatable and temporary spare parts and standby emergency spare parts;
- Consists of fuel, lubricants, water and similar items reasonably expected to be consumed in 12 months or less, beginning when first used in the taxpayer’s business;

- Is a unit of property with an economic useful life of 12 months or less, beginning when first used or consumed in the taxpayer's business;
- Is a unit of property with an acquisition or production cost of \$200 or less; or
- Is identified in published guidance as materials and supplies. *Treas. Reg. §1.162-3(c)(1)*.

Note: It is still possible that “materials and supplies” could satisfy the requirements for deductibility under the Regulations but still have to be capitalized under I.R.C. §263A (as an inventoriable cost) or *Treas. Reg. §1.263(a)-3* as an improvement.

Election. A taxpayer can annually elect to capitalize and depreciate rotatable or standby emergency spare parts. *Treas. Reg. §1.162-3(d)*. If the election is made, it can only be revoked by virtue of a letter ruling request – it can't be revoked by filing a method of change request. Also, the election can be made on an amended return if the original return was timely filed.

Safe Harbors

The final regulations establish a \$5,000 (per invoice or item) safe harbor for taxpayers that have an applicable financial statement (AFS) and had, at the beginning of the tax year, written accounting procedures for expensing amounts paid for property either costing less than a certain dollar amount or having an economic useful life of 12 months or less. Also, the taxpayer must treat such amounts as expenses on the taxpayer's AFS in accordance with written procedures. *Treas. Reg. §1.263(a)-1(f)(1)(i)*.

Under the final regulations, an AFS includes the following:

- A financial statement that must be filed with the Securities and Exchange Commission;
- A certified audited financial statement that is accompanied by the report of an independent CPA and used for credit purposes, reporting to owners, or any other substantial non-tax purpose; or
- A financial statement required to be provided to the federal or state government or any federal or state agencies (other than the SEC or the IRS). *Treas. Reg. §1.263(a)-1(f)(4)*.

Taxpayers that don't have an AFS can deduct amounts paid up to \$500 per invoice or item for property that has an economic useful life of 12 months or less if the taxpayer had, at the beginning of the year, written accounting procedures for expensing amounts paid for property either costing less than a certain dollar amount or with an economic useful life of 12 months or less and the taxpayer treats such amounts as expenses on the taxpayer's books and records in accordance with those written procedures. *Treas. Reg. §1.263(a)-1(f)(1)(ii)*. But, if the cost of an invoice or item is over \$500 nothing is deductible. For taxpayers that elect the de minimis safe harbor, a statement must be included on a timely filed original return for the year of the election that provides the taxpayer's name, address and I.D. number and specifies that the taxpayer is making the election under *Treas. Reg. §1.263(a)-1(f)*.

V. Iowa Property Tax Changes¹

Overview

Senate File 295 was passed by the 2013 Iowa General Assembly and was signed into law on June 12, 2013. This Act establishes a business property tax credit, establishes and modifies property assessment limitations, provides for commercial and industrial property tax replacement payments, classifies certain property as multi-residential property, provides an exemption for telecommunications company property, provides a taxpayers trust fund tax credit, modifies provisions relating to the Property Assessment Appeal Board, and modifies the amount of the state earned income tax credit.

The legislation contains four divisions:

- I – Business Property Tax Credit (applicable for property taxes due and payable in fiscal years beginning on or after July 1, 2014)
- II – Property Assessment Limitations and Replacement (effective June 12, 2013, and applicable to assessment years beginning on or after January 1, 2013)
- III – Multi-residential Property (effective January 1, 2015)
- IV – Telecommunications Company Property (effective June 12, 2013, and applicable retroactively to assessment years beginning on or after January 1, 2013)

Division I – Business Property Tax Credit

In general. New Iowa Code chapter 426C creates a business property tax credit (“credit”). One credit is available to each eligible parcel classified and taxed as commercial property, industrial property, or railway property. A parcel that is part of a “property unit” that is claiming the credit is not eligible for a separate credit. In essence, under the provision, the credit treats the first \$145,000 of value as if the business property being valued were residential property (which is more favorably taxed than is business property).

To qualify as a “property unit”, the parcels that make up the property unit must:

- 1) be “contiguous” (i.e. touching);
- 2) be located within the same county;
- 3) have the same property classification;
- 4) be owned by the same person; and
- 5) be operated by that person for a common use and purpose.

Property that is rented or leased to low-income individuals or families and that is assessed as Section 42 housing is not eligible for the credit or may not be part of a property unit that receives the credit.

Property that is a mobile home park, manufactured home community, land-leased community, assisted living facility, or property primarily used or intended for human habitation containing

¹ Special thanks to the Iowa Department of Revenue for their input on this portion of the additional handout material and the use of some of their summaries of the new legislation.

three or more separate dwelling units is eligible for the credit, and may be part of a property unit that receives the credit, for fiscal years beginning July 1, 2016 and each year thereafter.

Filing for the credit. Once a claim has been filed and the credit is allowed there is no need to re-file the claim as long as the parcel or property unit continues to qualify for the credit.

To receive the credit against taxes due and payable during the fiscal year beginning July 1, 2014, businesses must file a claim not later than January 15, 2014. Thus, the first year for which the credit will be available is for property taxes that are due in October of 2014.

For taxes due and payable for fiscal years beginning on or after July 1, 2015, businesses must file a claim with the county assessor no later than the March 15 immediately preceding the fiscal year in which the taxes are due and payable. So, to receive a credit for taxes due and payable for fiscal year beginning July 1, 2015, businesses must file a claim no later than March 15, 2015. The assessor will make an initial decision as to whether the property for which the credit is sought qualifies and will make that decision known to the county auditor. The auditor then will provide the assessor's findings to the county board of supervisors, who determine whether to grant the credit for any particular parcel. A denial of the credit carries with it appeal procedures to the local district court upon written notice provided no more than 20 days from the mailing of the notice of denial.

If the property ceases to qualify for the credit, the owner is required to provide written notice, by March 15 preceding the fiscal year in which the taxes are due and payable, to the county assessor informing the assessor that the property no longer qualifies for the credit.

If the ownership of all or a portion of a parcel or property unit that is allowed a credit changes, the new owner must file a new claim for the credit. If the ownership of a portion of a parcel or property unit that is allowed a credit changes, the owner of the portion or property unit for which ownership did not change must re-file the claim for credit.

The business property tax credit is paid out of a newly-created business property tax credit fund. For fiscal year beginning July 1, 2014 and 2015, there is appropriated from the general fund to the business property tax credit fund \$50,000,000 and \$100,000,000, respectively. For fiscal year beginning July 1, 2016, and each year thereafter, \$125,000,000 is appropriated from the general fund to the business property tax credit fund. As a result of the phased-in funding, it is possible that the credit will not cover the first \$145,000 in value during the first-year the new credit is available. But, at its fullest, the credit on the first \$145,000 of value would result in a credit of approximately \$3,100.

Iowa Department of Revenue Audit. If the Department determines that the amount of the credit was incorrectly calculated or that the credit is not allowable, the Department shall recalculate the credit and notify the claimant and the county auditor of the recalculation or denial and the reasons for it. The Department has three years from October 31 of the year in which the claim was filed to adjust the business property tax credit. The claimant or board of supervisors may appeal any decision of the Department to the state board of tax review. The claimant, the

board of supervisors, or the Department may seek judicial review of the action of the state board of tax review.

Penalty for false claims. A person who makes a false claim for the purpose of obtaining a credit or who knowingly receives the credit without being legally entitled to it is guilty of a fraudulent practice.

Division II – Assessment Limitations

Agricultural and residential property. Under prior law, for property valuations established as of January 1, 1980, and each year thereafter, the increase in the assessed value of agricultural and residential property was limited to 4 percent. The percentage of growth was required to be the same for agricultural and residential property; therefore, if one of these classes of property had less than 4 percent growth for a year, the other class was limited to the same percent of growth.

Under the legislation, for property valuations established as of January 1, 2013, and each assessment year thereafter, the increase in the assessed value of agricultural and residential property is limited to 3 percent. The percentage of growth must be the same for agricultural and residential property; therefore, if one of these classes of property has less than 3 percent growth for a year, the other class is limited to the same percent of growth.

This section of the legislation is effective June 12, 2013, for assessment years beginning on or after January 1, 2013.

Commercial, industrial and railroad property. Under prior law, for property valuations established as of January 1, 1981, and each year thereafter, commercial and industrial property, and railroad company property taxed under Chapter 434 was assessed at 100 percent of its actual value.

Under the legislation, for property valuations established for the assessment year beginning January 1, 2013, commercial and industrial property and railroad company property taxed under Chapter 434 is assessed at 95 percent of its actual value. For property valuations established for the assessment year beginning January 1, 2014, and each assessment year thereafter, commercial and industrial property and railroad company property taxed under Chapter 434 is assessed at 90 percent of its actual value. For a \$500,000 commercial building, the reduced tax rate would lower property taxes by approximately \$2,350 on an annual basis. As indicated above, this provision is effective June 12, 2013, for assessment years beginning on or after January 1, 2013.

Commercial and industrial property tax replacement. Beginning with the fiscal year beginning July 1, 2014, a county may make a claim to the Department for an amount equal to the total amount of the commercial and industrial property tax replacement claims (“replacement claims”) made by the taxing districts located within the county. Generally speaking, the replacement claim is the tax lost by a taxing district as a result of the rollback of the commercial property and industrial property. This provision is effective June 12, 2013, for assessment years beginning on or after January 1, 2013.

Division III - Multi-Residential Property Classification

In general. Under prior law, Iowa had four property classifications: Residential, Agricultural, Commercial, and Industrial. When a city or county established an urban revitalization area, it was required to specify whether the revitalization is applicable to none, some, or all of the property assessed as residential, agricultural, commercial or industrial property within that urban revitalization area.

Commercial property consisting of three or more separate living quarters with at least 75 percent of the space used for residential purposes and residential property were eligible to receive 100 percent exemption from taxation for ten years on the actual value added by improvements if they were located within an urban revitalization area.

Under the legislation, beginning with property valuations established on or after January 1, 2015, Iowa will have a fifth property classification known as “multi-residential property.” Such property will be valued as a separate class of property at a percentage of its actual value, and is defined as follows:

- Mobile home parks;
- Manufactured home communities;
- Land-leased communities;
- Assisted living facilities;
- Property primarily used or intended for human habitation containing three or more separate dwelling units.
- The portion of a building that is used or intended for human habitation and a proportionate share of the land upon which the building is situated, regardless of the number of dwelling units located within the building, if the use for human habitation is not the primary use of the building and such building is otherwise classified as residential property.

For parcels that partially satisfy the requirements for classification as multi-residential property, the assessor shall classify that portion of the parcel as multi-residential property. The remaining portion of the parcel shall be classified as the classification for which it qualifies.

Note: Property that is rented or leased to low-income individuals or families which is assessed as Section 42 housing or a hotel, motel, inn, or other building where rooms or dwelling units are usually rented for less than one month cannot be classified as multi-residential property.

Actual, assessed and taxable value. For property valuations established for the assessment year beginning January 1, 2015, the percentage of actual value of multi-residential property must be the greater of 86.75 percent or the percentage of actual value at which residential property is assessed for the same assessment year. The percentage will be reduced for each subsequent assessment year until the assessment year beginning January 1, 2022. For the assessment year beginning January 1, 2022, and each year thereafter, multi-residential property will be assessed at the same percentage of actual value as residential property for the same assessment year.

Note: Any construction or installation of a solar energy system on property classified as multi-residential will not increase the actual, assessed, and taxable value of the property for five full assessment years.

Division IV – Exemption for Telecommunication Company Property

In general. Telephone and telegraph companies operating a line in the State of Iowa are centrally assessed by the Iowa Department of Revenue. The Department finds the actual value of the companies' property by considering information they report annually. The Department uses that information to calculate an actual value per Iowa line mile. As centrally assessed property, telecommunication company property currently is taxed upon 100% of its value per Iowa line mile.

Under the legislation, a tiered property tax exemption will apply to specified portions of value of the company's property. The exemption percentage is tied and applied to each specified portion of the property's value. The provision applies beginning with assessment year 2013.

Other Provisions

The legislation also directs the Iowa Department of Revenue to study the property tax treatment of companies that provide telecommunications services, and makes changes to the property assessment appeal board – with the primary change being that the existence of the board is extended through June 30, 2018.

VI. Iowa Beginning Farmer Tax Credit, Beginning Farmer Custom Farming Tax Credit and Beginning Farmer Loan Program

Beginning in 2007, a new non-refundable credit (with a carryover of any unused credit for the earlier of five years or until credit depleted) became available for persons ("asset owners") who enter into qualified arrangements (2-5 year leases) with a "beginning farmer." Capped at \$50,000, the credit can have the potential to entirely eliminate Iowa state income tax for individuals that lease farm property to a beginning farmer for several years. This credit is known as the "Beginning Farmer Tax Credit."

Important Adjustments to the Beginning Farmer Tax Credit Program (Effective January 1, 2013):

- Maximum Net Worth of "Beginning Farmer": \$691,172 (Iowa Code §175.2.12, adjusted for inflation annually on January 1)
- Program Fee: \$200 application fee plus \$100 for each year of crop-share/flex lease (to be collected at time of application)
 - Note: The additional amount is \$50 for each year of a cash/flex lease.
- Amount of credit:

- 7 percent for cash rent lease
- 17 percent for crop-share lease

Other Items:

- For crop share leases, acres will be allocated 50% to corn and 50% to soybeans, unless other crop acres are specifically identified in the lease for other crops.
- Flex leases will be calculated using cash rent lease base only, with no additional credit calculated based on the flex farms.
- All tax credit calculations are to be completed by using the county historical average T-yield data with the price being the previous year's RMA fall price.
- Completed applications are due to the Iowa Agricultural Development Division (IADD) by the first of each month. In addition, an application must be submitted by September 1 for the asset owner to be eligible for the credit for that year.

General Guidelines

- An “agricultural asset” is defined as “agricultural land, depreciable agricultural property, crops, or livestock.” Non-depreciable property is not an “agricultural asset” for purposes of the credit.
- Rental of a rural residence is not allowed and if it is part of a lease agreement, the lease value of the residence must be identified and excluded from calculation of the credit.
- Land enrolled in the Conservation Reserve Program is not allowed for purposes of computing the credit.
- An eligible taxpayer is one that does not violate that Iowa anti-corporate farming law or qualify under that provision solely by means of an exemption.
- Eligible taxpayers include related parties (e.g. father, grandfather, etc.).
- The credit is available for individuals and corporate taxpayers, as well as, members of pass-through entities. For pass-through entities, the amount is based on the member’s pro-rata share of earnings from the entity.
- In order to receive the tax credit the taxpayer must execute a written contract (known as an “asset transfer agreement”) for the transfer of the assets.

NOTE: A taxpayer will not become ineligible for the credit as a result of a consensual termination of a prior agreement with the beginning farmer, followed by the parties entering into a new asset transfer agreement meeting the beginning farmer tax credit eligibility requirements. However, the taxpayer cannot be at fault for terminating a prior lease.

- Asset transfer agreements can be as short as two (2) years or as long as five (5) years.
- The lease can be modified after IADD has approved it if there is a life changing event (e.g., death, divorce, name or address change) and IADD is notified of the change.
- The amount of the tax credit is limited to those items addressed in the asset transfer agreement, and is based on the gross amount paid to the taxpayer under the asset transfer agreement.

- A copy of the agreement must be included with the application to the IADD. The credit can only be claimed if the taxpayer has received a tax credit certificate from the IADD. The certificate must be attached to the taxpayer's return.
- The phrase "beginning farmer" is a misnomer. A "beginning farmer" must be at least 18 years of age and there is no upper age limit. Also, a "beginning farmer" must satisfy the net worth requirement specified above and have "sufficient education, training and experience for the anticipated farm operations." In addition, a "beginning farmer" must have access to adequate working capital, farm machinery, livestock and agricultural land.
- The tax credit certificate will be issued in the taxpayer's name in the amount of 7% of a cash agreement and 17% for a crop or livestock-share agreement.
- The taxpayer may carry any unused portion of the credit forward for up to five (5) years, but may not carry the credit back to a prior tax year.
- The credit is non-transferable to any other person. However, it can be transferred to the taxpayer's estate or trust upon the taxpayer's death.
- The beginning farmer cannot be a shareholder, partner or LLC member of the lessor.
- IADD will require yearly financial statements and some evidence of adequate working capital or access thereto.
 - The statement must be completed within 30 days before submission of the application. The statement must be witnessed by a bank officer and signed by all applicants and lender.
- Beginning farmer will be required to submit copy of Sch. F to IADD by each April 15th.
- Iowa tax form IA148 must be completed and attached to the taxpayer's return.

The IADD cannot issue a tax credit certificate if any of the following apply:

- The taxpayer is at fault (as determined by the IADD) for terminating a previous contract under the Iowa Beginning Farmer Tax Credit Act. In that event, any prior tax credit will be disallowed and the credit is immediately due and payable to the Iowa Department of Revenue.
- The taxpayer is party to any pending administrative or judicial actions (whether contested or not) related to alleged violations involving an animal feeding operation.
- The taxpayer is classified as a habitual violator for violations involving animal feeding operations.

Examples:

John and Mary, husband and wife, own 320 tillable acres of Iowa farm real estate. John is ready to retire and turn their farming operation over to their son, Tom. Tom is currently age 25 and his net worth is less than \$691,172. Tom qualifies as a beginning farmer for purposes of the Iowa Beginning Farmer Tax Credit.

John and Mary intend to either (1) cash rent their 320 tillable acres to Tom at \$350 per tillable acre (\$112,000 total); or (2) enter into a 50/50 crop-share lease with Tom. John and Mary would be eligible for a seven percent tax credit under the cash rental arrangement and a 17 percent tax credit under the crop-share arrangement (160 acres corn; 160 acres beans) as follows:

- * Cash rental tax credit = \$7,840 (\$112,000 x 7%) per year
 - * Crop-share tax credit = \$18,054 per year assuming the following:
 - Corn – 160 acres x 170/bu. per acre x \$4.50 x ½ = \$61,200 gross receipts
 - Beans – 160 acres x 45/bu. per acre x \$12.500 x ½ = \$45,000 gross receipts
- Total gross receipts = \$106,200 x 17% = \$18,054

NOTE: IADD has indicated that tax credit certificates will be issued for crop-share arrangements based on the average county crop yield at the average county crop price for the month in which harvest was completed.

Beginning Farmer Custom Farming Tax Credit

Enacted into law in 2013, the Beginning Farmer Custom Farming Tax Credit provides an Iowa tax credit to persons hiring a “beginning farmer” to do agricultural contract work involving the production of crops or livestock in Iowa. The qualifications of the “beginning farmer” under this program are identical to those for the beginning farmer tax credit as discussed above.

There is a \$200 application fee (but no closing fee) and the credit is available to the person that contracts with a “beginning farmer” to do ag custom labor. The maximum credit is \$50,000, and the amount of the credit is seven percent on the amount actually paid to the beginning farmer. The contract must be for a duration of less than 12 months. Payment for the custom labor must be verified, and an additional credit of one percent is available the first year if the beginning farmer is a military veteran.

Beginning Farmer Loan Program

The beginning farmer loan program began in 1981, and utilizes tax-exempt bonds to provide “beginning farmers” with a reduced interest rate over the life of the loan. Beginning farmer loans are financed by lenders that participate in the program (or contract sellers) via the issuance of federal tax-exempt bonds offered by the IADD. The lender’s interest income is tax-exempt for federal income tax purposes and the seller’s interest income is exempt from both federal and state of Iowa income tax. As a result, beginning farmer loans commonly are characterized with an interest rate in a range from one to four percentage points under market rates.

The net worth requirement for the beginning farmer borrower is the same as for the beginning farmer tax credit – less than \$691,172. The loan maximums are \$501,100 for land, \$250,000 for farm improvements, \$125,000 for new depreciable property and \$62,500 for used depreciable property. Corporations, partnerships and LLC’s are ineligible borrowers. A \$50 application fee applies along with a 1.50% loan closing fee on the first \$250,000 and 0.75% on any remaining amount. The application deadline for program applications is the first day of the month. The application must be accompanied by a financial statement, a background letter. The IADD will conduct a public hearing during its board meeting to determine whether to approve the bond resolution. Once the bond resolution is approved, the parties may close the loan.

Beginning farmer loans are also available for transactions between parents, grandparents and siblings. However, such related-party transactions must be financed via third-party lenders.

VII. Farm Income Averaging

Farm income averaging has been on the books for several years. With the reinstatement of the 39.6 percent top tax bracket, almost all higher income farmers will receive a tax benefit from using farm income averaging, however, care must be taken to maximize its potential.

Now is the time to consider helping your farm clients understand the merits of using farm income averaging and changes they may want to consider making to their current rental arrangements (whether as the landlord or tenant).

How Farm Income Averaging Works

A farmer can elect to average all or part of their current year farm income over three years. If the farmer makes the election, the elected farm income is treated as earned in the previous three years. Thus, the elected farm income is allocated to the three previous years (base years) in equal amounts. You cannot pick and choose the amount to allocate to each year.

A farmer in their first year of farming may utilize farm income averaging. There is no requirement to be a farmer in any of the prior three years. *Treas. Reg. §1.1301-1(b)(1)(iv)*.

Farm income is comprised of the following income:

- Net income reported directly on schedule F;
- Net farm income that flows through from a partnership or S corporation;
- Guaranteed payments received by a partner in a farm partnership;
- Wages earned by an owner of an S corporation engaged in farming. *Treas. Reg. §1.1301-1(e)(1)*;
- Net gains from the sale of personal property and any farm buildings or structures associated with the farming business. *Treas. Reg. §1.1301-1(e)(ii)(A)*; and
- Crop share income. *Treas. Reg. §1.1301-1(b)(2)*:
 - Must be a written lease,
 - Must be executed before the tenant begins significant activities on the land
 - The landlord is not required to materially participate in the tenant's farming business.

Farm income does not include:

- Income, gain or loss from the sale of farmland. *Treas. Reg. §1.1301-1(e)(ii)(A)*;
- Income, gain or loss from the sale of development rights, grazing rights, and other similar rights. *Treas. Reg. §1.1301-1(e)(i)*; and

- Any rents received not based upon production (i.e. cash rents or flex rents based on change in market prices). *Treas. Reg. §1.1301-1(b)(2)*.

Once the farmer determines the amount of electable farm income, they prepare Schedule J and attach it to the tax return. In brief, this schedule itemizes the amount of total taxable income for the current year, the amount of farm income elected to be averaged, and a schedule of the net taxable income and tax paid for the three base years.

This election can be made late or the farmer can amend a previously made election, only if the taxpayer does so in conjunction with another adjustment that affects taxable income of the election year or any of the base years. This adjustment can be caused by a variety of items such as a net operating loss (NOL), I.R.C. §179 changes, an audit change, or any other change that results in filing an amended tax return.

Note: The ability to make a late election is of major benefit. For example, in significant parts of South Dakota an early fall blizzard decimated cattle herds for many ranchers and will result in significant NOLs.

Electable farm income may not exceed taxable income, thus if the taxpayer's taxable income is less than net farm income, the maximum amount of electable farm income is limited to taxable income.

Why 2013 is Important

With the top 39.6 percent rate applied to taxable income exceeding the higher income definition, then the use of farm income averaging may save substantial amounts of federal income tax. This reduction will usually be greatest in 2013, but additional lower savings will occur in 2014 and 2015.

The following examples illustrate this point:

Example # 1 – Low income in 2010-2012, then high income in 2013-2015

Assume a married farmer has net taxable income of zero for 2010, \$25,000 for 2011 and \$75,000 in 2012. The farmer has \$700,000 of taxable income for 2013 (assume eligible farm income equals taxable income). Without farm income averaging, the total tax owed for 2013 is \$223,346. If the farmer elects to spread \$300,000 of farm income, their tax bill will drop by about \$35,000. If their income is the same for 2014 and 2015, then would save an additional \$12,000 in 2014 and about \$1,000 in 2015. Their total savings would be about \$48,000 over the three years.

If they elect to spread the whole income, their savings actually are reduced since they are not taking advantage of the 15% bracket fully in each year. The total three year savings drops from about \$48,000 to \$37,000. The election of about \$300,000 provides the maximum three year savings.

Example # 2 – High income in all years (2010-2015)

Assume a farmer has farm and taxable income of \$1 million for each year from 2010-2015. If they elect to spread \$750,000 for years 2013-2015, they save about \$30,000 in year one, \$23,000 in year 2 and \$11,500 in year 3 or a total three year savings of about \$64,000.

If they elect to spread the whole \$1 million each year, the three savings drops to only \$52,000. The optimum level is close to the \$800,000. Even though the highest tax rate has increased from 35% to 39.6%, a taxpayer still needs to make sure to utilize their lower brackets each year.

Revising Rental Agreements

A key provision of farm income averaging is that rental arrangements must be based on production to qualify. If the payment is fixed (i.e. cash rents) or if the payment is adjusted based on changes in market prices (i.e. most flex leases), this income does not qualify for farm income averaging.

Additionally, beginning in 2013, there is an additional 3.8 percent tax on net investment income under I.R.C. §1411 based upon the lesser of:

- Net investment income; or
- Amounts in excess of \$200,000 modified AGI (single) or \$250,000 modified AGI (married filing joint).

Since this tax is based upon either (a) investment income or (b) modified adjusted gross income, this tax *cannot* be reduced using farm income averaging.

However, if taxpayers expect their taxable income for 2013 to be primarily income from cash rents, they may want to consider changing their lease in writing to make it some type of crop share arrangement. By making this change, the taxpayer is able to create income that can be elected for farm income averaging even if they had no income in prior years that qualified.

Through the use of crop insurance and other hedging options, the taxpayer may be able to almost lock in the same amount or net rental income, yet may be able to save a substantial amount of money in 2013-2015 by using this type of rental arrangement (assuming they are in the highest income tax bracket and assuming they are still able to revise their lease in writing).

VIII. IOWA CASES AND RULINGS

1. *Qwest Corporation v. Iowa State Board of Tax Review, No. 11-1543, 2013 Iowa Sup. LEXIS 38 (Iowa Sup. Ct. Apr. 12, 2013)*(plaintiff (recently purchased by CenturyLink) challenged on equal protection grounds the constitutionality of Iowa Code §§ 476.95-.101 that imposes taxes on equipment of traditional telephone companies, but imposes tax only a portion of some equipment of long-distance providers and practically no equipment of wireless providers; Court upheld statute on basis that plaintiff continued to maintain "monopoly power" and, as such, it was rational for legislature to conclude that taxing plaintiff's personal property was "an appropriate way to capture some of their monopoly rent" while "relieving potential developers of competing infrastructure from a similar burden").

2. *In re Marriage of Looney, No. 2-903, 2013 Iowa App. LEXIS 372 (Iowa Ct. App. Apr. 10, 2013)*(appeal of child support modification; at trial, wife showed difference in farmer's income if straight line depreciation used; farmer's income would have been double; and court adopted these figures and a five-year average; on appeal, modification affirmed).
3. *Iowa Department of Revenue Policy Letter (Doc. No. 12201044, Sept. 26, 2012)*(policy letter provides illustration of how the "10 and 10" requirement of the capital gain exclusion functions when taxpayer owns business real estate in one entity and operates the business in another entity; IDOR says that taxpayers can exclude gain on sale of the business real estate (or entire business) that is held for 10 years and is used in the business in which the taxpayer materially participates for 10 years; letter notes that IA follows I.R.C. Sec. 469 rules for determining material participation; letter notes that exclusion applies to taxpayer who is a non-resident and (in second scenario) owns real estate in different entity that in which material participation occurs; letter notes that I.R.C. Sec. 469 would deem net income from self-rental as non-passive).