SELECTED 2016 TAXATION ISSUES FOR IOWA FARMERS

By Kristine A. Tidgren[i]

November 2016

It has been estimated that the Internal Revenue Code and its accompanying regulations comprise more than 10 million words. The complexity is staggering. Yet, every taxpayer is expected to follow every mandate. Business taxpayers, including farmers, should always seek out trusted tax advisors to guide them through the thorny tax code. The money paid for good counsel is a wise and necessary investment.

Nonetheless, it is important that all taxpayers educate themselves regarding the Tax Code and the provisions that most impact them. Following is a concise, alphabetized list of some key tax provisions important to Iowa farmers. It is not intended to be all-inclusive or to offer tax advice. Rather, this review is designed as an educational reference guide, a starting place so to speak for some of the issues about which we, at the Center, most often field questions. It contains recent updates, notes unique Iowa provisions, and directs the reader to further resources for in-depth analysis or information. We hope it is useful.

4H and FHA Projects

The net income from sales or prizes related to a 4-H or FHA project is subject to income tax. If the project is primarily for educational purposes and *not for profit*, the income will not be subject to self-employment tax. Such income should typically be reported as "other income" on line 21, Form 1040. If, however, the project is not primarily educational, but is part of regular and recurring business activity (i.e. raising livestock), the net income will be subject to self-employment tax and should be reported on Schedule F.

See also Publication 225, Page 72.

Affordable Care Act

Individual Responsibilities

The Affordable Care Act implemented an "individual mandate," which requires taxpayers to have "minimum essential coverage" for themselves and their dependents or pay a "shared responsibility payment." This payment is due when the taxpayer files his or her tax return. The shared responsibility payment for 2016 is the *higher* of these two amounts:

$695 per adult and $347.50 per child (under 18), up to a maximum of $2,085 OR

2.5% of family income above the filing threshold

If a taxpayer qualifies for one of a number of exemptions, he or she may not be liable for the shared responsibility payment. One key exemption is where the lowest priced coverage available to the taxpayer (either through the Marketplace or through an employer-provided plan) would cost more than 8.13% of household income. More information regarding health coverage exemptions can be found at https://www.healthcare.gov/health-coverage-exemptions/forms-how-to-apply/.

Employer Responsibilities

Employer with fewer than 50 full-time equivalent employees are not required to offer health care coverage to their employees. If they do, however, they must follow Affordable Care Act requirements. The Affordable Care Act requires that all employer-provided health care coverage (regardless of the size of employer) meet certain requirements. Coverage may not impose annual dollar limits or cost sharing for preventive health services. These requirements apply equally to employer reimbursement plans and traditional group health plans. Because the IRS has determined that standalone reimbursement plans (those not "integrated" with an employer-provided group health plan) do not satisfy these requirements, employers who offer such plans are subject to hefty excise taxes (up to $100/day/employee).

Generally, an employer of any size may no longer offer a health reimbursement account (HRA), medical expense reimbursement plan (MERP), or flexible spending account (FSA) to their employees *unless* that employer *also* provides group health coverage to its employees. Several exceptions to this general rule do exist. Standalone plans are still allowed in the following narrow instances:

- Plans with fewer than two participants who are current employees
- Plans that offer only *excepted* benefits, including:
    - Accident-only coverage
    - Disability income
    - Certain Long-term care
    - Limited scope dental and vision benefits
    - Employee Assistance Program benefits
    - Medicare Supplement benefits

More detailed information on this topic can be found on the CALT website. The article, *Health Reimbursement Plans Not Compliant with ACA Could Mean Exorbitant Penalties* is a good starting point.

Bonus Depreciation

The PATH Act (signed December 18, 2015) extended 50 percent bonus depreciation, but only for a time. Congress chose to phase-out this benefit over a five-year period. Under this provision, producers can claim an additional first-year tax deduction equal to 50 percent of the value of qualifying property placed into service during tax years 2015, 2016, and 2017. Congress then reduced the depreciation amount to 40 percent in 2018 and 30 percent in 2019. Bonus depreciation is slated to disappear altogether for property placed into service in 2020 or later.

The bonus depreciation deduction, which is available only for *new property*, applies to farm buildings, in addition to equipment. Unlike the §179 expense allowance, there is no limit on the overall amount of bonus depreciation that a producer may claim. If an item of property qualifies for both §179 expensing and bonus depreciation, the §179 expensing amount is computed *first*, and then bonus depreciation is taken based on the item's remaining income tax basis. It is also important to note that §179 expensing is based on when the taxpayer's tax year begins, whereas bonus depreciation is tied to the calendar year.

The Iowa Legislature did not couple with this federal provision in 2015 and has not (as of November 2016) coupled with this provision for 2016 or beyond.

See IRC § 168(k).

Trees and Vines

The PATH Act also provided a special election to farmers who plant trees or vines that bear fruits or nuts. They may choose to deduct 50 percent of the cost of planting those trees or vines in the year of planting. This rule applies to both farmers who have elected out of the Uniform Capitalization Rules (UNICAP) and those who have not. Without this special provision, bonus depreciation is not available to farmers who have elected out of UNICAP. Likewise, without this special provision, all tree and vine farmers are required to capitalize planting costs, rather than deduct them. This special provision is only in place through 2019. Like other bonus depreciation provisions, it is phased-out for property placed into service after 2017:

2016 – 50%
2017 – 50%
2018 – 40%
2019 – 30%

Passenger Automobiles

The PATH Act allows $8,000 in additional first year depreciation for passenger automobiles placed in service in 2016 or 2017. This amount is reduced to $6,400 in 2018 and $4,800 in 2019.

Built-In Gains Tax

Generally, S corporation shareholders are subject to pass-through taxation. Shareholders pay tax on the gain from the sale of the S corporation's assets. There is typically no corporate-level or "double" taxation with an S corporation, as there is with a C corporation. That rule may be different, however, when a C corporation reorganizes into an S corporation. When the reorganized S corporation subsequently sells appreciated assets, the S corporation may be subject to a 35% corporate-level tax on gains that accrued while the entity was a C corporation, in addition to the tax imposed on the shareholders. Importantly, this double tax is imposed only during a statutory "lookback" period. The PATH Act permanently set this lookback period at five years. Consequently, for federal tax purposes, an S corporation that has converted from a C corporation may avoid the corporate-level (built-in gains) tax by waiting five years from the time the S corporation is formed to sell appreciated assets.

The Iowa Legislature has not yet coupled with this provision for 2016. It is expected that these discussions will begin when the 2017 session convenes in January.

Charitable Contributions

Charitable Donations from IRAs

The PATH Act has made permanent a provision allowing an IRA owner who is 70 ½ years of age or older to exclude from income up to $100,000 of funds gifted from an IRA to a qualified charity.

Charitable Gifting of Grain

Cash-basis farmers may recognize additional tax savings by gifting grain to a charity directly rather than selling the grain and then gifting the proceeds. A gift of grain is different from a post-sale donation to the charity because the income from the grain is never received by the farmer. Thus, the tax savings flows from removing the income *before* recognition, rather than from taking a charitable deduction *after* recognizing the income. This can greatly benefit those taxpayers who do not itemize deductions. Furthermore, materially participating farmers benefit from gifting grain because lower income means less self-employment tax.

To qualify for the savings, certain technical steps must be followed. To survive scrutiny, the commodity must be unsold inventory in the hands of the farmer. Title to the commodity must be transferred to the charity *before* the grain is sold. For example, the corn would be delivered to the elevator with a storage receipt made out to the charity. The charity receives a letter from the farmer stating the corn belongs to the charity and that the charity may sell the corn as it sees fit. The grain elevator should only issue a check to the charity once the charity has given a specific instruction to sell.

Farmers considering a year-end grain gift should consult with a tax professional to review any potential savings and to ensure that the proper steps are followed.

Contributions of Food Inventory

Because they have no basis in food they have grown, cash basis farmers would generally receive no charitable deduction for donations of food inventory. The PATH Act changed this result by allowing cash basis farmers to elect a basis of 25% of the fair market value of *apparently wholesome food* for purposes of taking a charitable deduction for donations.

Under this provision, a farmer selling sweet corn at a farmers' market, for example, could donate the leftover produce to a food pantry and claim a deduction for the donation. The deduction can equal an amount up to *basis plus one-half of the amount of profit had the produce sold*. The deduction cannot exceed, however, 15% of net farm income *or* two times the basis.

Conservation Easements

The PATH Act made permanent several provisions relating to donations of qualified conservation easements. Farmers and ranchers who donate qualified conservation easements are eligible to deduct from their income the value of the easement in an amount up to 100 percent of their contribution base, which is generally their adjusted gross income. A person is a qualified farmer or rancher for this purpose if his or her gross income from farming is more than 50 percent of gross income for the year. For amounts that cannot be deducted in the year of the donation, a 15-year carryover period applies.

This is a complex area of tax law that requires the assistance of an experienced tax practitioner. IRS evaluates these donations very carefully to ensure they are not "abusive transactions." To recognize the tax benefit, a donated conservation easement must be a legally binding, permanent restriction on the use, modification, and development of the property. As such, the land use restrictions will bind all current and future owners.

Under the tax code, a qualified conservation contribution is a donation of a (1) qualified real property interest to a (2) qualified organization, (3) exclusively for conservation purposes. A "qualified real property interest" is one granting a restriction on the use of real property granted in perpetuity. A "qualified organization" is defined by regulation as a governmental or charitable organization committed to protecting the conservation purposes of the donation. Easements with a "conservation purpose" include easements that:

- Preserve land areas for outdoor recreation by, or the education of, the general public.
- Protect a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem.
- Preserve open space (including farmland and forest land) for a public benefit, including those donated for a use consistent with public programs to protect water supplies or maintain or enhance water quality.
- Preserve of a historically important land area or a certified historic structure.

Other Charitable Contributions

For taxpayers who itemize, standard charitable deductions can also result in tax savings. Donors should ensure, however, that they receive a "contemporaneous written acknowledgement" from the charity before claiming the deduction for any single contribution of $250 or more.

The acknowledgement must state that no goods or services were provided by the organization in exchange for the contribution. Without such an acknowledgement, the IRS will disallow the deduction if the taxpayer is audited. It is a taxpayer's responsibility to obtain the acknowledgment before the tax return is filed. A cancelled check or other evidence of payment is not sufficient.

CCC Loans, Section 77 Election and Revocation

While loans are not typically included as income, IRC § 77 allows farmers to elect to treat Commodity Credit Corporation loans as income if the farmer has used a commodity as collateral for the loan. If such an election is made, the farmer includes the amount of the loan in his or her gross income for the taxable year in which the proceeds of the loan were received. The election is made on a timely filed return and applies to all subsequent returns unless that election is revoked. To revoke the election, the farmer files a Form 3115 with his or her return. IRS consent is automatic.

Commodity "Wages"

Paying an agricultural employee in commodities rather than cash will usually exempt the payment from FICA/FUTA taxes. On the flip side, the employees' social security benefits may be reduced accordingly (depending upon their amount of other wages). Consequently, commodity wages are often supplemented with cash wages to maintain social security benefits.

To ensure that commodity "wages" are excluded from the definition of "wages" for purposes of FUTA/FICA and income withholding requirements, proper procedures must be followed. The services must be for *agricultural* labor, which includes services performed in connection with the operation, even if the work involves management or maintenance.

A payment of commodity wages must be evidenced by a receipt, contract, or other instrument showing that an actual transfer occurred. And, most importantly, the employee must, as of the date of the payment, *exercise dominion and control over the commodity*. The employer reports the FMV of the commodity on a W-2 as "other income." For more information on in-kind payments to agricultural employees, please see the IRS publication, *Market Segment Understanding Guidelines for Agricultural Labor — Noncash Remuneration*.

Conservation Easements

See Charitable Contributions section above.

Conservation Expenses

Active farmers may be able to presently deduct the cost of conservation practices implemented as part of an NRCS (or comparable state)-approved plan. The IRC § 175 soil and water conservation deduction (which is taken in the year the improvements are made) can be elected for conservation expenditures in an amount up to 25 percent of the farmer's gross income from farming. The deduction can only be taken for improvements made on "land used for farming." Excess amounts may be carried forward to future tax years. Non-farming landowners (such as those who cash rent their ground) must capitalize these expenses (add the cost of the improvement to the basis of the property) because the IRC § 175 deduction only applies to taxpayers "engaged in the business of farming."

> **Note**: The IRC § 175 deduction is not available for the purchase of depreciable assets (those that have a useful life). Furthermore, the cost of seed and other "ordinary and necessary" business expenses would be deductible in the year expended as ordinary business expenses, apart from IRC § 175. Cost sharing or incentive payments received to implement these conservation programs would be taxed as ordinary income.

If a landowner who has taken a soil or water conservation deduction sells his property after holding it for five years or less, he or she will have to pay ordinary income taxes on the gain from the sale, up to the amount of the past deduction. If the property was held for less than 10 years, but more than five, that ordinary income rate is assessed against only a percentage of the prior deduction amount.

Cost Share Payment Exclusion for Conservation Practices

IRC § 126 provides for the exclusion of income for certain cost-sharing payments made pursuant to a recognized federal or state conservation, reclamation, or restoration program. The cost-sharing exclusion provisions do not apply to expenses a taxpayer can deduct in the year of purchase. The § 126 exclusion was put into place for capital assets, such as a concrete erosion control structure, built in furtherance of recognized conservation programs. This incentive was implemented to prevent farmers or landowners from having to recognize excessive income in the year the cost-sharing payment was made since the cost of such improvements could only be depreciated over years. Since these structures or devices enhance conservation, but typically do not increase farm income, IRC § 126 was designed to offset the financial disincentive.

To qualify for IRC § 126 income exclusion, four "tests" must be met:

- The payment must be made pursuant to a "qualifying program."
- The cost-sharing payment must be for a capital expense. Payments for a presently deductible expense are not covered by IRC § 126.
- The payment must not substantially increase annual income from the property for which it is made. An increase in annual income is substantial if it is more than the greater of the following amounts.
- The Secretary of Agriculture must certify that the payment was primarily made for conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

The provision is complex, but generally, the amount of the cost-sharing payment that the taxpayer may exclude from income is the present value of the greater of:

- Ten percent of the average annual income derived (gross receipts) from the affected property for the last three years **or**
- $2.50 times the number of affected acres.

The taxpayer is responsible to define the "affected property." The larger the area defined, the greater the income exclusion amount. Section 126 applies to operating farmers and crop share or cash rent landowners, as well as rural non-farming landowners. Taxpayers claiming this exclusion must attach a statement to their tax return including the (1) dollar amount of the government payment, (2) the value of the improvement, and (3) the amount the taxpayer is excluding. Cost-share payments are reported on Schedule F, line 4a, with the taxable amount reported on line 4b.

It's important to realize that payments excluded from income are subject to income recapture in much the same way as excess depreciation or expense deductions. If a taxpayer who claims a § 126 income exclusion for a cost sharing payment sells or otherwise disposes of the property within 20 years of receiving the excluded payment, he or she must treat as ordinary income all of the cost-sharing payments excluded. It should also be noted that taxpayers cannot take depreciation, amortization, or depletion deductions for the part of the cost of the property for which cost-sharing payments were excluded from income.

For more information on cost-sharing, see page 11 of IRS Publication 225.

Child Tax Credit

Most taxpayers can claim a $1,000 tax credit for each child under the age of 17 who is claimed as a dependent on their tax return. This is a credit, not a deduction, meaning that it offsets tax liability, dollar for dollar. The child tax credit begins to phase out when taxpayers reach certain income levels. In 2016, for married taxpayers filing jointly, this phase-out begins when modified adjusted gross income reaches $110,000. The *additional child tax credit* is *refundable*. Taxpayers eligible for the additional child tax credit can receive a refund of the credit, even if no income tax was due. The PATH Act permanently established that an otherwise eligible taxpayer need only have $3,000 in earned income to be eligible for the refundable credit. Because of new fraud protections instituted by Congress, taxpayers who claim the additional child tax credit for the 2016 tax year, will not receive a refund before February 15, 2017.

Earned Income Credit

The earned income credit is a tax credit for working people with low to moderate incomes. The credit offsets tax liability dollar-for-dollar and is refundable if the amount of the credit exceeds tax liability. The amount of the credit depends upon income and number of qualifying children. For 2016, for example, the maximum credit for married filing jointly taxpayers with three or more children is $6,269. This credit phases out for adjusted gross income ranges between $23,740 and $53,505. Investment income must also be $3,400 or less to claim the credit. Because of new fraud protections instituted by Congress, taxpayers who claim the earned income credit for the 2016 tax year will not receive a refund before February 15, 2017.

Crop Insurance Deferral

Farmers can elect to postpone reporting some or all crop insurance income until the year following receipt of the income if the following conditions are met:

- The farmer uses the cash method of accounting.
- The farmers receives the crop insurance proceeds in the same tax year the crops are damaged.
- The farmer can show that under normal business practice he or she would have included income from the damaged crops in any tax year following the year the damage occurred.

To make this election, the farmer reports the amount of the crop insurance proceeds on line 6a of Schedule F but does not include the amount as taxable income on line 6b. The farmer then checks the box on line 6c and attaches a statement including the following:

- Name and address of the taxpayer farmer.
- A statement that farmer is making an election under IRC section 451(d) and Regulations section 1.451-6.
- The specific crop or crops physically destroyed or damaged.
- A statement that under normal business practice the farmer would have included income from some or all of the destroyed or damaged crops in gross income for a tax year following the year the crops were destroyed or damaged.
- The cause of the physical destruction or damage and the date or dates it occurred.
- The total payments received from insurance carriers, itemized for each specific crop, and the date each payment was received.
- The name of each insurance carrier from whom payments were received.

An election is binding for the year unless the IRS approves your request to change it. Deferral is not allowed for proceeds received from revenue insurance policies.

CRP Payments and SE Tax

Payments received under the Conservation Reserve Program are taxable income, usually subject to self-employment tax. In 2008, however, Congress specifically provided that taxpayers receiving old age or survivor's benefits or disability benefits are not liable for *self-employment tax* on their CRP payments. So, farmers or non-farmers who receive social security benefits are *not liable* for self-employment taxes on that income.

Additionally, in 2014, the United States Court of Appeals for the Eighth Circuit ruled that CRP payments made to a *non-farmer* (someone not materially participating in a farming activity) were not subject to self-employment tax. In 2015, the IRS declared that it would only follow the 8th Circuit's ruling for cases where the payments were made to a person not engaged in farming and **paid prior to January 1, 2008**. A **non-farmer** receiving CRP payments in the 8th Circuit (which includes Iowa) should have substantial authority for taking a position that no self-employment tax is due. Nonetheless, the IRS has stated that it will challenge this position if discovered.

Social security recipients should report CRP payments on the Form 1040 Schedule F, Line 4b. They should then back out the amount of the CRP payment on Line b of Form 1040, Schedule SE, to exclude the payment from SE tax liability.

See Morehouse v. Commissioner, 769 F.3d 616 (8th Cir. 2014), rev'g 140 T.C. 350 (2013) and IRS October 13, 2015, Action on Decision, IRB 2015-41.

DPAD

The Domestic Production Activities Deduction, which has been in place in one form or another since 2004, currently provides a deduction of 9 percent of the lesser of taxable income or qualified production activities income. The deduction is also limited, however, to 50% of the wages paid by the taxpayer during the year. Consequently, farmers who do not pay wages to any employees are not allowed the deduction. Commodity wages, wages paid to children under the age 18, and non-taxable fringe benefits do not qualify as wages for DPAD purposes.

Agricultural cooperatives can pass all or a portion of their DPAD through to their patrons. This deduction is reported on Form 1099-PATR, box 6, and *can be claimed by a farmer who has no employees.* The cooperative must also send the farmer a written notice designating the patron's share of the DPAD.

See IRS Publication 225, page 23.

Drainage Tile

Drainage tile modifications or installations are generally depreciable over a 15-year period. Materially participating operators are eligible for IRC § 179 expensing and 50 percent bonus depreciation for the cost of new tile installation. Non-materially-participating landowners could also depreciate the cost of the drainage tile improvements over a 15-year period. Although they are not eligible for IRC § 179 expensing (since they are not in the business of farming), they would eligible for 50 percent bonus depreciation for the cost of new tile (so long as all other requirements are met).

Easement Issues – Wind Farms and Pipelines

Many farmers have conveyed easements for wind farms, pipelines, or other projects. Some have had the easements taken through eminent domain. Permanent and 30-year easements are treated for tax purposes like a sale of the property. The landowner reduces his or her basis in the property in the amount of the purchase price of the easement. Any amount below zero would be IRC § 1231 gain reported on Form 4797. It is taxed at long-term capital gains rates as long as the property was owned for more than one year (but see recapture section under Conservation Expenses section above). Easement payments offered for easements in place less than 30 years are taxed as ordinary income. Easement payments are not subject to self-employment tax. The IRS does require owners to conduct a basis allocation when calculating the tax treatment for the easement. In other words, if the easement does not impact an entire tract, the landowner may only reduce the basis of the portion of the tract impacted.

It should be noted that easements granted for 30 years or more can qualify for like-kind exchange treatment under IRC § 1031. Similarly, an easement taken through eminent domain proceedings will generally qualify for exchange treatment under IRC § 1033.

Unharvested crops on the property at the time the easement is granted receive IRC § 1231 treatment, as long as the underlying property qualifies (i.e. held for more than one year). If the owner is a materially participating farmer, crop damages for future crops are reported on Schedule F as ordinary income. Payments made to compensate owners for the temporary use of land during construction are rental payments reported on Schedule E.

Education Expenses

American Opportunity Tax Credit

The PATH Act made the American Opportunity Tax Credit permanent. This credit, which can be up to $2,500 each year for the cost of qualified education expenses, is available for four years *if the student has not completed the first 4 years of postsecondary education before the beginning of the fourth taxable year*. Up to $1,000 of the credit may be refundable. The credit is available for qualified education expenses such as tuition and required materials and supplies. The cost of room and board is not an eligible expense. Taxpayers must report the EIN of the institution when they claim their credit. They should receive from the institution a Form 1098-T reporting amounts paid, although some institutions may still be reporting only the amounts billed. In 2016, the taxpayer must have the Form 1098-T to claim the credit.

The IRS provides a great Q & A regarding the credit here: https://www.irs.gov/uac/american-opportunity-tax-credit-questions-and-answers.

College Savings Iowa 529 Plans

Iowa taxpayers can contribute to College Savings Iowa 529 accounts to pay the qualified higher-education expenses of their children, grandchildren, or other benefactors. These funds provide donors and beneficiaries with a number of important tax benefits. Money contributed to the fund is allowed to grow, tax free, and is not taxed when it is withdrawn to pay for qualified expenses. Although there is no federal tax deduction for contributions, donors can contribute up to $70,000 in a single year for a single beneficiary (MFJ taxpayers can contribute up to $140,000) without incurring any federal gift tax liability, as long as that donor does not make any other gifts to that beneficiary for five years.

Iowa allows donors to deduct the amount of donations up to **$3,188** *per beneficiary* from their Iowa income for 2016. The donation need only be made by the due date of the Iowa return, to qualify for the deduction against 2016 Iowa income.

New in 2016, tax-exempt, nonprofit organizations under IRC section 501(c)(3) were added to the list of entities that can open and contribute to an individual's Iowa College Savings 529 Plan on behalf of an individual

Energy Credits

Nonbusiness Energy Property Credit

The PATH Act extended the nonbusiness energy property credit, but only through the 2016 tax year. Taxpayers who make improvements such as insulation, energy-efficient exterior windows and doors, and certain roofs may be eligible for a credit of 10 percent of the cost of the improvements, up to $500 or $200 in the case of windows. The cost of installation is not included in the credit calculation. In 2016, windows, skylights, and doors must be Energy Star 6.0 to qualify for the credit.

See IRC §25C.

Residential Energy-Efficient Property Credit

In the Consolidated Appropriations Act of 2016, Congress extended the Residential Energy-Efficient Property Credit or REEP Credit for five years. The extension applies only to property placed in service before 2022 and only to qualified solar electric property expenditures and qualified solar water-heating property expenditures. The credit is as follows:

Thru 2019: 30%

Thru 2020: 26%

Thru 2021: 22%

Congress did not extend credit for cell property, wind energy property, and geothermal heat pump property. Consequently, this credit expires for property placed in service **after December 31, 2016. See IRC § 25D and https://www.irs.gov/credits-deductions/individuals/residential-energy-efficient-property-credit.**

Iowa currently has a **geothermal tax credit** equal to 20% of the federal residential energy efficient property tax credit allowed for geothermal heat pumps in residential property located in Iowa. This will remain in place for property place in service by December 31, 2016. If the REEP credit with respect to geothermal property is not renewed by Congress, the Iowa credit for property place in service in 2017 will be 10 percent of the taxpayer's qualified expenditures on equipment that uses the ground or groundwater as a thermal energy source to heat the taxpayer's dwelling, or as a thermal energy sink to cool the dwelling.

Estate, Gift, and Generation Skipping Tax

Federal Estate Tax

Congress has established a basic exclusion amount which is the amount of a person's property at death (including lifetime gifts) that is exempt from estate tax. For 2016, that exclusion amount is $5.45 million. In 2017, it increases to $5.49. This is the amount of money that a person can give away during their lifetime or at their death and not be subject to any estate tax. Amounts gifted or bequeathed above the exclusion amount are subject to an estate tax rate of 40%. A Form 706 must be filed to pay this estate tax.

Apart from the basic exclusion, taxpayers can gift up to $14,000 per year, per person, to as many people as they wish without ever having to count this gift amount against their lifetime exclusion. No gift tax returns need to be filed for gift amounts at or below this special "annual exclusion." This annual exclusion amount remains at $14,000 per year through 2017. Annual gifts to a single person by a single donor above $14,000 must be reported on a Form 709 gift tax return.

In 2012, Congress also made it possible for spouses to share their basic exclusion amount by making a *portability* election. If the executor of the deceased spouse's estate makes this election, the estate transfers to the *surviving* spouse its unused exclusion amount (if any). The surviving spouse, at death, can then apply the unused exclusion amount of the last deceased spouse to his or her own transfers. The portability election is made by filing a Form 706 at the death of the first spouse. If the form is not filed, the surviving spouse will not be able to later apply the deceased spouse's unused exclusion amount to his or her estate.

Iowa Inheritance Tax

Iowa imposes an inheritance tax, but only on transfers to certain beneficiaries. In Iowa, property passing to a surviving spouse, parents, grandparents, great-grandparents, and other lineal ascendants is exempt from inheritance tax. Similarly, property passing to children (biological and legally-adopted children), stepchildren, grandchildren, great-grandchildren, and other lineal descendants is also exempt from inheritance tax. For deaths on or after 7/1/2016, property passing to the lineal descendants of stepchildren is also exempt from inheritance tax. **Not** exempt from the Iowa inheritance tax is property passing to siblings, aunts, uncles, friends, etc. Up to $25,000 of assets are exempt from any tax. After that, Iowa has a special schedule detailing the rate of the tax. The rate is dependent upon the relationship of the beneficiary to the decedent. The schedule for 2016 is here:
https://tax.iowa.gov/sites/files/idr/forms1/Rate%20Sch%20%2860061%29_1.pdf

Estimated Taxes

Generally, taxpayers, must have income taxes withheld by an employer throughout the year or make quarterly payments of estimated tax, including income tax and self-employment tax.

A special rule applies to *qualified farmers*. An individual is a qualified farmer if at least two-thirds of his or her gross income from all sources for current tax year or prior tax year was from farming.

Qualified farmers are exempt from the penalty for failing to file estimated taxes if they:

- File their return and pay all tax due by March 1 OR
- Their income tax withholding will be at least 66 2/3% of the total tax shown on their current year tax return or 100% of the total tax shown on their prior year return.

If a qualified farmer must pay estimated tax, he or she is required to make only one estimated tax payment (the required annual payment) by January 15, 2016, using special rules to figure the amount of the payment. If the qualified farmer chooses this option, he or she can file the return and pay the remainder of the tax due on the standard tax filing deadline, which is typically April 15 (April 18 in 2017).

Iowa also requires the quarterly payment of estimated taxes, but gives farmers who derive 2/3 of their income from farming the option to do one of the following in lieu of making quarterly estimated payments:

1) They may pay the entire estimated tax by January 15 following the tax year and file the tax return by April 30 (May 1 in 2017) OR

2) They may file the income tax return and pay the tax in full on or before March 1 of the year following the tax year.

Fertilizer and Lime

Electing to Expense

Under IRC § 180, taxpayers engaged in the business of farming may elect to immediately expense the cost of fertilizer and lime, rather than depreciate it over the term of its useful life. The election is for one year only, but once such an election is made, it may not be revoked without the consent of the IRS. This provision applies both to tenants and landlords if the rent is based upon production. Cash rent landlords who do not materially participate in the farming operation may not take advantage of this tax benefit.

Allocating Residual Fertilizer to Purchase Price

Although there is no clear guidance on this issue, it appears that the IRS would likely allow a purchaser of farmland (given the right set of facts) to allocate a portion of the purchase price to the residual fertilizer purchased with the farmland. The purchaser could then continue to depreciate the cost of that fertilizer over the period of its remaining life after the purchase. This conclusion is drawn from T.A.M. 199211007, which is not legal precedent, but may present substantial authority for taking this position on a tax return. The existence of substantial authority does not mean that the IRS will agree with the taxpayer's position. Rather, it means that the IRS will not assess an accuracy-related penalty if the agency disagrees with the position taken.

In T.A.M. 199211007, the IRS disallowed the taxpayer's attempt to amortize the cost of residual fertilizer supply. However, the reason given for the advice was that, under the facts presented, the taxpayer was not the beneficial owner of the residual fertilizer supply. The IRS determined that the beneficial owners of the fertilizer were the owners of the land, not the corporate taxpayer that had separately purchased the residual supply.

The advice, however, goes on to suggest that if the taxpayer had been the beneficial owner of the residual fertilizer supply, the amortization may have been proper if the following were also true:

- The taxpayer establishes the presence and extent of the fertilizer purchased with the land
- The taxpayer establishes the level of soil fertility attributable to fertilizer applied to the land by the previous owner
- The taxpayer provides a basis upon which to measure the increase in the level of fertility in the land in question
- The taxpayer establishes that he is exhausting the fertilizer in the soil
- The taxpayer provides evidence indicating the period of time over which the fertility attributable to the residual fertilizer will be exhausted

Thus, the documentation required to take this position is not simple. It is important to again state that this is an unsettled area of the law. Taxpayers purchasing real property should consult with their tax advisors regarding their options with respect to the treatment of residual fertilizer.

Filing Deadlines

Federal individual income tax returns for the 2016 tax year will be due on April 18, 2017. This is because of a weekend and a Monday federal holiday. Iowa returns are due on May 1, 2017, because April 30 falls on a Sunday.

Individual filers may seek an automatic six-month federal extension for filing their return by filing a Form 4868 (and including the amount of their estimated tax payment) or by paying estimated taxes due through DirectPay. Remember that an extension to file does not delay the deadline for payment of the tax. If you do not pay the amount owed by the original filing deadline, you will be liable for interest and possible penalties.

Iowa taxpayers who have paid at least 90% of their taxes owed by the Iowa due date automatically have until October 31 to file their Iowa return.

Beginning in 2017, employers must file their information returns (W-2s, 1099s for non-employee compensation) with the Social Security Administration by January 31. This is the same date the forms are required to be provided to the employees and independent contractors.

Entity return due dates have also been modified by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015.

2016 Returns for calendar-year partnerships (Form 1065) and S Corporations (Form 1120-S) are due March 15, 2017. A sixth-month automatic extension (through September 15, 2017) is also allowed. Returns for fiscal year partnerships and S Corporations are due in 2017 on or before the

15th day of the third month following the close of the fiscal year. These returns may also receive an automatic six-month extension.

The due date for 2016 C corporation returns is the 15th day of the fourth month (instead of the third month) following the corporation's taxable year. This change is applicable to tax years beginning after December 31, 2015, unless the corporate year ends on June. In such case, the new deadlines will not apply for 10 more years.

Under the new law, C corporations may also be granted a new six-month extension. However, calendar-year C corporations may receive a five-month extension and C Corporations with a year end of June 30 may receive a seven-month extension for the next 10 years.

Iowa Capital Gain Deduction

Since 1990, the Iowa Legislature has allowed qualifying small business owners and farmers to deduct at least a portion of the capital gains income they realize from the sale of their business-related property. The rules have evolved through the years, but currently, under Iowa Code § 422.7(21), a full capital gain deduction is allowed in Iowa for net capital gain stemming from the sale of the following property:

- Real property (such as farmland) used in a business in which the taxpayer materially participated for 10 years immediately prior to the sale, when that property has been held for a minimum of 10 years immediately prior to its sale.
- A business in which the taxpayer materially participated for 10 years, when that business has been held for a minimum of 10 years immediately prior to its sale.
- Cattle and horses used for breeding, draft, dairy, or sporting purposes and held for 24 months by the taxpayer who received more than half of his or her gross income from farming. Where the purchaser is a lineal descendent (child, grandchild, stepchild, or adopted child), the income limitation does not apply.
- Breeding livestock other than cattle and horses, held for 12 months by the taxpayer who received more than half of his or her gross income from farming or ranching. Where the purchaser is a lineal descendent (child, grandchild, stepchild, or adopted child), the income limitation does not apply.
- Timber held by the taxpayer for more than one year.

In addition, 50% of the gain from the sale or exchange of employer securities of an Iowa corporation to a qualified Iowa employee stock ownership plan (ESOP) may also be eligible for the Iowa capital gain deduction. For more information on the Iowa Capital Gain Deduction, visit the Iowa Department of Revenue's website: https://tax.iowa.gov/iowa-capital-gain-deduction.

For 2016, Iowa has unveiled a new Form IA 100 series. It should make the reporting process simpler than 2015.

Net Investment Income Tax

The Net Investment Income Tax (NIIT) is a tax imposed on passive income by the Affordable Care Act, beginning in 2013. Individuals will owe the tax if they have net investment income and a modified adjusted gross income above the following threshold amounts:

- $125,000 if married filing separately,
- $250,000 if married filing jointly or qualifying widow(er), or
- $200,000 if single or head of household

NIIT is 3.8% of the **lesser of** net investment income **or** the excess of modified adjusted gross income over a threshold amount. The NIIT is reported on Form 8960.

Prepaid Expenses

Cash basis farmers are usually allowed to prepay some expenses by purchasing farm supplies in one year that they will not use until the following year. This provision may be helpful, for example, if 2017 income is expected to be lower than 2016 income. To qualify for this special treatment, the prepaid farm expenses may not exceed 50% of other deductible farm expenses. Likewise, to qualify for the prepayment deduction—which applies to inputs such as feed, seed, fertilizer and similar farm supplies—the farmer must make an *actual purchase* rather than just a deposit. The product purchased must be used or consumed in the next 12 months. The farmer must also have a business purpose (such as fixing a maximum price or ensuring supply) for the prepayment other than merely tax avoidance. Finally, deducting the prepayment must not result in a material distortion of the farmer's income.

Record Keeping Requirements

Farmers must keep good records, both for tax purposes and for business purposes. Great software is available to assist with both efforts. All documents relating to tax returns should be kept for at least three years from the date the return is filed or due or two years from the date the tax was paid (whichever is longer). Records relating to assets must be kept for the life of the asset and beyond. Taxpayers must be able to access depreciation records and properly calculate the basis in the event the asset is sold or gifted. Employment records relating to the farming operation should be kept for at least four years.

Section 179

The PATH Act permanently extended an enhanced "section 179" deduction for 2015 and beyond. For 2016, farmers and small businesses can deduct up to $500,000 of the tax basis of certain business property or equipment placed into service that year. Once qualifying purchases reach a threshold of $2,010,000 in 2016, the amount of the deduction is reduced, dollar-for-dollar for each dollar above the threshold. The section 179 deduction, as well as the threshold, are indexed for inflation. In 2017, the deduction increases to $510,000.

The section 179 deduction applies to both new and used business equipment. Because it applies to 15-year property or less, it does not apply to farm buildings, but can be used for single purpose agricultural structures, such as a hog barn.

In addition to setting a higher deduction amount, the PATH Act also made permanent a provision allowing revocation of the Section 179 election without IRS consent. Once the election is revoked, it cannot again be elected.

The Iowa Legislature coupled with federal provisions for Section 179 for the 2015 tax year. However, no such coupling has occurred for 2016. The Iowa Legislature will begin to debate this matter when it reconvenes in January.

Tangible Property Regulations

On September 19, 2013, the IRS and the Treasury Department published final regulations (T.D. 9636) distinguishing capital expenditures from supplies, repairs, maintenance, and other deductible business expenses. Called the Tangible Property Regulations, these regulations went into effect January 1, 2014.

Treas Reg. § 1.263(a)-1 provides taxpayers with a new option to elect a de minimis safe harbor. If this election is made, the taxpayer need not determine whether every small dollar expenditure for the acquisition of property is properly deductible or capitalized under the complex acquisition and improvement rules of the regulations. For taxpayers without an applicable financial statement, the safe harbor amount in 2016 is $2,500. If the taxpayer has an accounting procedure in place to expense such amounts, he or she can make the *annual* election. This election is not an accounting method change, but is made by attaching a statement to a timely filed original return. Once made for a particular tax year, every purchase of tangible property falling within the range of the election must be expensed. A taxpayer cannot choose to apply the safe harbor to some items and not to others. Generally, a taxpayer may not file an amended return to either make or revoke the election.

It is important to note that if a taxpayer later sells property expensed under the safe harbor at a gain, the taxpayer must pay ordinary income tax on the entire sale price. This is not considered IRC § 1221 or § 1231 property. These sales would be reported on Form 4797 (Part II) (Sales of Business Property). If the property was not held for sale in the ordinary course or inventory, the gain should not be subject to self-employment tax.

For more detailed information on the new tangible property regulations, see the IRS Audit Technique Guide: https://www.irs.gov/pub/irs-utl/tangiblepropertyatg9142016.pdf

---

[i] Kristine is an attorney and the Assistant Director of the Center for Agricultural Law & Taxation at Iowa State University.