DESCRIPTION OF MISCELLANEOUS FARM-RELATED TAX PROPOSALS (S. 226, S. 531, S. 545, S. 882, S. 1615, S. 1691, AND S. 1814)

Scheduled for a Hearing

Before the

SUBCOMMITTEE ON
ENERGY AND AGRICULTURAL TAXATION

of the

SENATE COMMITTEE ON FINANCE

on October 5, 1994

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Subcommittee on Energy and Agricultural Taxation of the Senate Committee on Finance has scheduled a public hearing on October 5, 1994, to consider various farm-related tax proposals. These proposals are: (1) S. 226 (estate tax recapture from cash leases of specially valued property); (2) S. 531 (increase the unified estate and gift tax credit); (3) S. 545 (treatment of gains or losses from certain dispositions by farmers' cooperatives); (4) S. 882 (rollover of gain from the sale of farm assets into an asset rollover account); (5) S. 1615 (treatment of livestock sold on account of weather-related conditions); (6) S. 1619 (tax credit for environmental pollution control property and for soil and water conservation expenditures); and (7) S. 1814 (treatment of certain crop insurance proceeds and disaster assistance payments).

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law and the bills (in numerical order) that are the subject of the hearing.

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[1] This document may be cited as follows: Joint Committee on Taxation, Description of Miscellaneous Farm-Related Tax Proposals (JCX-23-94), October 3, 1994.

DESCRIPTION OF BILLS

1. S. 226 (Senators Daschle, Baucus, Boren, Conrad, and Others)

Estate Tax Recapture from Cash Leases of Specially Valued Property

Present Law

A Federal estate tax is imposed on the value of property passing at death. Generally, the value of property is its fair market value, that is, the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

Under section 2032A of the Code, the executor may elect to value certain "qualified real property" used in farming or another qualifying trade or business at its current use value rather than its highest and best use. If, after the special use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years (15 years for individuals dying before 1982) of the decedent's death, an additional estate tax is imposed in order to "recapture" the benefit of the special use valuation (sec. 2032A(c)).

Some courts have held that the cash rental of specially valued property after the death of the decedent is not a qualified use and, therefore, results in the imposition of the additional estate tax. Martin v. Commissioner, 783 F.2d 81 (7th Cir. 1986) (cash lease to unrelated party); Williamson v. Commissioner, 93 T.C. 242 (1989) (cash lease to family member).

Explanation of the Bill

The bill would provide that the cash lease of specially valued real property by a qualified heir to a "member of the family"[2] (who continues to operate the farm or closely held business) does not cause the qualified use of such property to cease for purposes of imposing the additional estate tax under Code section 2032A(c).

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2 A member of the family, with respect to an individual, includes an ancestor, spouse, lineal descendant, lineal descendant of such individual's spouse or parents, and any spouse of any such lineal descendant (sec. 2032A(e)(2)).

Effective Date

The bill would apply to rentals occurring after December 31, 1976.

2. S. 531 (Senators Durenberger and Hatch)

Increase the Unified Estate and Gift Tax Credit

Present Law

The Federal Government imposes a transfer tax on the cumulative property transfers made by gift or at death in excess of an amount exempted by a unified credit. Since 1987, the amount of the unified credit has been fixed at $192,800, which effectively exempts a total of $600,000 in taxable transfers from the estate and gift tax. The benefits of the unified credit are phased out by a 5-percent surtax imposed upon taxable transfers over $10 million and not exceeding $21,040,000.

The unified credit was originally enacted in the Tax Reform Act of 1976. As enacted, the credit was phased in over five years to a level (i.e., a unified credit of $47,000) that effectively exempted $175,625 of taxable transfers from the estate and gift tax in 1981. The Economic Recovery Tax Act of 1981 increased the amount of the unified credit each year between 1982 and 1987, from an effective exemption of $225,000 in 1982 to an effective exemption of $600,000 in 1987. The unified credit has not been increased since 1987.

Explanation of the Bill

The bill would increase the present-law unified credit to an amount (i.e., $345,800) that would effectively exempt $1,000,000 in taxable transfers from the estate and gift tax.[3]

Effective Date

The bill would apply to the estates of decedents dying, and gifts made, after the date of enactment.

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[3] A conforming amendment to the 5-percent surtax would be necessary to permit the increased credit to phase out properly under S. 531. S. 531, as presently drafted, does not contain such a conforming amendment.

3. S. 545 (Senators Boren, Baucus, Danforth, Daschle, Dole, Durenberger, Grassley, Reigle, Roth, and Others)

Treatment of Gains and Losses from Certain Dispositions by Farmers' Cooperatives

Present Law

In general

Unlike other corporations, a cooperative association is allowed to exclude from its taxable income any patronage dividends paid to its members or patrons or amounts paid in redemption of a nonqualified written notice of allocation (sec. 1382).[4] Members of a cooperative association who receive patronage dividends must treat the dividends as income, reduction of basis, or some other treatment that is appropriately related to the type of transaction that gave rise to the dividend. For example, where the cooperative association purchases equipment for its members, patronage dividends attributable to equipment purchases are treated as a reduction in the recipient's basis in the purchased equipment (provided the recipient still owns the equipment).

Definition of patronage dividend

In general, a patronage dividend means an amount paid to a patron (1) on the basis of the quantity or value of business done with or for such patron, (2) under an obligation of the cooperative association to pay such amount, which obligation existed before the association received the amount so paid, and (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons. Such term does not include any amount paid to a patron to the extent that such amount is out of earnings other than from business done with or for patrons, or such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially

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[4] Additionally, cooperative associations may reduce their gross income by the amount of qualified per-unit retain certificates and the amounts paid for redemptions of nonqualified per-unit retain certificates. A per-unit retain certificate is, in general, a written notice that sets forth the "per-unit retain allocation", that is, the allocation by the cooperative association to a patron with respect to goods marketed by the cooperative association for the patron, which is not determined by reference to the net earnings of the organization.

identical transactions.

Definition of income derived from sources other than patronage

Treasury regulations provide that "...'income derived from sources other than patronage' means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises, from investment in securities, or from the sale or exchange of capital assets, constitutes income derived from sources other than patronage" (Treas. Reg. sec. 1.1382-3(c)(2)). Notwithstanding the language of the Treasury regulations, both the Internal Revenue Service and the courts have held that, in some cases, income of the types described in the Treasury regulations may constitute income derived from patronage sources.[5]

Also, the Internal Revenue Service has ruled that any gain treated as ordinary income under the depreciation recapture rules of section 1245 is treated as patronage source income in the same portion that the depreciation deductions were taken (Rev. Rul. 74-84, 1974-1 C.B. 244). The ruling further held that any additional gain that is treated as capital gain is not patronage-sourced income.

Explanation of the Bill

In general

Under the bill, a "farmer cooperative" could elect to

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[5] See, e.g., Rev. Rul. 69-576, 1969-2 C.B. 166 (patronage dividend from cooperative bank on loans used for patronage business considered patronage source income because it "...facilitates the accomplishment of the cooperative's marketing, purchasing, and service activities...."); Astoria Plywood Corporation v. United States, 79-1 U.S.T.C. par. 9197 (D. Ore. 1979)(payments for cancellation of a lease on a building used by cooperative for patronage-sourced activities were patronage source income); Land O'Lakes, Inc. v. United States, 675 F. 2d 988 (8th Cir. 1982)(dividends from stock in bank held to be patronage source income where the acquisition of the bank's stock was necessary to receive financing for patronage activities); St. Louis Bank for Cooperatives v. United States, 624 F. 2d 1041 (Ct. Cl. 1980)(interest earned on short-term investment of temporary excess cash of a cooperative bank held to be patronage source income).

include gain or loss on the sale or other disposition of certain assets in the determination of net earnings done with or for patrons. For this purpose, a "farmer cooperative" would be defined as any farmers', fruit growers', or like organization or association to which part I of subchapter T applies.

Assets to which the bill applies

The bill would apply to any asset (including stock or any other ownership or financial interest in another entity), or portion thereof, that is used by the cooperative to facilitate the conduct of business done with, or for, its patrons (herein referred to as a "patronage asset"). Where an asset is not used exclusively to facilitate the conduct of business done with, or for, the farmer cooperative's patrons, the bill would apply only to the extent that the asset is used to facilitate the conduct of business with, or for, its patrons. Allocating the use of the asset between patronage and non-patronage operations could be determined by any reasonable method. The bill also would require that section 1231 be applied separately to patronage gains and losses and nonpatronage gains and losses.

Rules applicable to election

An election made under the bill would apply to all sales (or other dispositions) of patronage assets during the taxable year for which the election is made and all subsequent taxable years until revoked by the farmer cooperative. Following a revocation of its election and absent the consent of the Treasury Department, a farmer cooperative would not be eligible to make an election under this bill until the third taxable year following the taxable year for which the revocation is effective. A revocation would be effective upon the filing of notice with the Treasury Department.

Effective Date

The bill would be effective for sales or other dispositions of property occurring in taxable years beginning after the date of enactment.

4. S. 882 (Senator Kohl)

Rollover of Gain from the Sale of Farm Assets into an Asset Rollover Account

Present Law

Under present law, gain from the sale of farm assets is generally includible in income for the taxable year in which the assets are sold.

Explanation of the Bill

The bill would permit a qualified farmer to defer recognition of a limited amount of net gain from the sale of qualified farm assets to the extent the farmer contributes an amount equal to such gain to one or more asset rollover accounts ("ARAs") in the taxable year in which the sale occurs. An ARA would be an individual retirement arrangement ("IRA") that is designated at the time of establishment as an ARA. Except as provided under the bill, an ARA would be treated in the same manner as an IRA. Thus, amounts contributed to an ARA (and earnings on such amounts) would be includible in income when withdrawn from the ARA. However, unlike IRAs, no deduction would be allowed for contributions to an ARA, and rollover contributions to an ARA could be made only from other ARAs.

Contributions to one or more ARAs (and thus deferral of qualified net farm gain) in any taxable year would be limited to the lesser of (1) the qualified net farm gain for the taxable year, or (2) an amount determined by multiplying the number of years the taxpayer is a qualified farmer by $10,000 ($20,000 for joint filers in each year the taxpayer's spouse also is qualified farmer). In addition, the aggregate amount for all taxable years that could be contributed to all ARAs established on behalf of an individual could not exceed $500,000 ($250,000 in the case of separate return by a married individual), reduced by the amount by which the aggregate value of assets held by the individual and the individual's spouse in IRAs (other than ARAs) exceeds $100,000. A taxpayer would be deemed to have made a contribution to an ARA on the last day of the preceding taxable year if the contribution is made on account of such taxable year and is made not later than the time prescribed by law for filing the individual's Federal income tax return for the year (not including extensions).

Under the bill, qualified net farm gain would be defined as the lesser of (1) the net capital gain of the taxpayer for the taxable year, or (2) the net capital gain for the taxable year determined by taking into account only gain (or loss) in

connection with a disposition of a qualified farm asset. A qualified farm asset would be an asset used by a qualified farmer in the active conduct of the trade or business of farming. A qualified farmer would be a taxpayer who during the 5-year period ending on the date of the disposition of a qualified farm asset materially participated in the trade or business of farming, and 50 percent or more of such trade or business is owned by the taxpayer (or spouse) during the 5-year period.

Any individual who made a qualified contribution to, or who received any amount from, an ARA for any taxable year would have to include on the individual's Federal income tax return for such taxable year and any succeeding taxable year (or on such other form as the Secretary may prescribe) information similar to that required in the case of designated nondeductible contributions to an IRA. Excess contributions to an ARA would be subject to the penalties applicable to excess contributions to an IRA.

Effective Date

The bill would apply to sales and exchanges occurring after the date of enactment.

5. S. 1615 (Senators Daschle, Durenberger, Grassley, and Others)

Treatment of Livestock Sold on Account of Weather-Related Conditions

Present Law

In general, taxpayers using the cash method report income in the year it is actually or constructively received. However, present law contains two special rules applicable to livestock sold on account of drought conditions. Code section 451(e) provides that a cash method taxpayer whose principal trade or business is farming and who is forced to sell livestock due to drought conditions may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income is available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought conditions that resulted in the area being designated as eligible for Federal assistance. This exception generally is intended to put taxpayers who receive an unusually high amount of income in one year because of a drought in the position they would have been in absent the drought.

In addition, the sale of livestock (other than poultry) that is held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought conditions is treated as an involuntary conversion under section 1033(e). Consequently, gain from the sale of such livestock may be deferred by reinvesting the proceeds of the sale in similar property within a two-year period.

Explanation of the Bill

The bill would amend Code section 451(e) to provide that a cash method taxpayer whose principal trade or business is farming and who is forced to sell livestock due not only to drought (as under present law), but also to floods or other weather-related conditions, may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income would be available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for the drought, flood or other weather-related conditions that resulted in the area being designated as eligible for Federal assistance.

In addition, the bill would amend Code section 1033(e) to provide that the sale of livestock (other than poultry) that is held for draft, breeding, or dairy purposes in excess

of the number of livestock that would have been sold but for drought (as under present law), flood or other weather-related conditions is treated as an involuntary conversion.

Effective Date

The bill would apply to sales and exchanges after December 31, 1992.

6. S. 1691 (Senators Conrad, Daschle, Durenberger, Grassley, and Others)

Tax Credit for Environmental Pollution Control Property and for Soil and Water Conservation Expenditures

Present Law

Present law does not provide tax credits for property used to control environmental pollution. However, Code section 48 does provide an energy tax credit for certain energy property (generally, equipment that uses solar energy or energy derived from a geothermal deposit) and a reforestation tax credit for qualified timber property.

In addition, under Code section 175, a taxpayer may deduct certain soil and water conservation expenditures. Such deductions generally cannot exceed 25 percent of gross income derived from farming in the year. Under Code section 169, a taxpayer can elect to amortize certain pollution control facilities over a five-year period. Only "new identifiable treatment facilities" are eligible for five-year amortization. Such facilities generally include only depreciable tangible property (not including a building and its structural components, unless the building is exclusively a treatment facility) that is constructed, reconstructed or erected by the taxpayer after December 31, 1968, or acquired after December 31, 1968, if the original use of the property commences with the taxpayer and commences after such date.

Explanation of the Bill

The bill would provide an "agricultural environmental credit" for property used in certain agriculture-related activities to control environmental pollution and for soil and water conservation expenditures. For any taxable year, the agricultural credit would be equal to the lesser of (1) the sum of (a) 15 percent of the basis of each "agricultural environmental property" placed in service during that year and (b) 15 percent of the amount allowed as a deduction under Code section 175, or (2) the lesser of (a) $15,000 or (b) the excess of $150,000 over the amount of credit previously claimed by the taxpayer in prior taxable years.

To be eligible for the credit, a taxpayer would have to be primarily engaged in a farming-related business, i.e., a farming business (within the meaning of Code sec. 263A(e)(4)), a trade or business of mixing fertilizers from purchased fertilizer materials, or a trade or business of the wholesale distribution of animal feeds, fertilizers, agricultural chemicals, pesticides, seeds or other farm supplies (other than grains).

"Agricultural environmental property" would be defined as any new, identifiable treatment facility (as defined in Code sec. 169(d)(4)(A), substituting December 31, 1993 for December 31, 1968) used in a farming-related business for the primary purpose of complying with Federal, State and local environmental laws dealing with the abatement or control of water, soil or atmospheric pollution or contamination by removing, altering, disposing, storing or preventing the creation or emission of pollutants, contaminants, wastes or heat. "Agricultural environmental property" would not include any expenditure that significantly increases the output, extends the useful life, or reduces the operating costs of the plant or property to which the facility relates or alters the nature of any manufacturing or production process or facility.

The credit could not be claimed on energy property (defined in Code sec. 48(a)(3)) or other property to the extent the basis of such property is attributable to qualified rehabilitation expenditures (defined in Code sec. 47(c)(2)). In addition, the amount that would be allowed as a deduction for soil and water conservation expenditures under Code section 175 would be reduced by the amount of the credit. Finally, no credit would be available for property to the extent an election is made under Code section 169 (amortization of pollution control facilities) with respect to the basis of such property.

Effective Date

The bill generally would be effective for property placed in service after December 31, 1993, subject to transition rules similar to the rules of section 48(m) (as in effect prior to enactment of the Revenue Reconciliation Act of 1990).

7. S. 1814 (Senators Daschle, Boren, Breaux, Conrad, Dole, Durenberger, Grassley, and Others)

Treatment of Certain Crop Insurance Proceeds and Disaster Assistance Payments

Present Law

A taxpayer engaged in a farming business generally may use the cash receipts and disbursements method of accounting ("cash method") to report taxable income. A cash method taxpayer generally recognizes income in the taxable year in which cash is received, regardless of when the economic events that give rise to such income occur. Under a special rule (Code sec. 451(d)), a cash method taxpayer may elect to defer the income recognition of insurance proceeds received as a result of destruction or damage to crops until the taxable year following the year of the destruction or damage, if the taxpayer establishes that, under the taxpayer's usual business practice, income from such crops would have been reported in a following taxable year. For this purpose, certain payments received under the Agricultural Act of 1949, as amended, or title II of the Disaster Assistance Act of 1988 are treated as insurance proceeds received as a result of destruction or damage to crops.

Explanation of the Bill

The bill would amend the special rule of section 451(d) to allow a cash method taxpayer to elect to treat certain disaster-related payments as received in the year of the disaster (even if the payments are received in the year following the disaster) so long as the taxpayer establishes that, under the taxpayer's usual business practice, income from the crops lost in the disaster would have been recognized in that year. The bill would retain the present-law election to defer the recognition of income in applicable situations.

The bill also would expand the payments for which these elections are available to include disaster assistance received as a result of destruction or damage to crops caused by drought, flood, or other natural disaster, or the inability to plant crops because of such a disaster, under any Federal law (rather than only payments received under the Agricultural Act of 1949, as amended, or title II of the Disaster Assistance Act of 1988).

Thus, for example, the bill would allow a calendar-year, cash-method taxpayer who has received disaster assistance payments in 1994 relating to the destruction of crops by a flood in 1993 to elect to treat such payments as received in

1993, so long as the taxpayer establishes that, under the taxpayer's usual business practice, income from such crops would have been reported in 1993.

Effective Date

The bill would be effective for payments received after December 31, 1992, as a result of destruction or damage occurring after such date.

Prior Action

S. 1814 was approved by the Senate Committee on Finance on March 24, 1994, with an amendment relating to the indexation of the threshold applicable to the excise tax on luxury automobiles (S.Rept. 103-244, April 5, 1994).