Trade or Business; Income Tax Basis; Cropper; and Like-Kind Exchanges

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Overview

Several things come to mind this afternoon concerning legal and tax issues for farmers and ranchers.

What is a Trade or Business Activity and Why it Matters?

Whether your farm or ranch activity is a trade or business according to the IRS matters greatly. Usually, the answer to the question is clear, but there can be confusion, and it's in those situations that the IRS might argue that deductions should be disallowed.

One of the biggest concerns surrounding whether an activity constitutes a trade or business is the allowance of deductions. If your farming or ranching activity is a trade or business, associated expenses are deductible and income qualifies for the 20 percent qualified business income deduction – for non C corporations. The downside, perhaps, is that it's also subject to self-employment tax.

Whether any activity is a trade or business is a fact-based analysis. The key case on the trade or business issue is the Supreme Court's decision in *Comm'r., v. Groetzinger*, 480 U.S. 23 (1987), established an important precedent for defining what constitutes a "trade or business" for tax purposes. The taxpayer spent significant time and effort as a full-time gambler, focusing on greyhound racing. He argued that his gambling activities qualified as a trade or business, which would allow him to deduct his gambling losses under I.R.C. §162(a). The IRS disagreed, contending that his gambling was not a trade or business because it lacked the traditional characteristics of a business, such as employees or an intent to sell goods or services.

The Supreme Court ultimately ruled in favor of the taxpayer. The Court concluded that if an individual is engaged in an activity with continuity and regularity and the primary purpose of the activity is for income or profit, it qualifies as a trade or business. The Court emphasized that the determination must focus on the facts and circumstances of each case, rather than relying solely on rigid definitions or formalities.

Note: This decision is significant because it broadened the understanding of what could be considered a trade or business, providing greater flexibility for taxpayers engaged in nontraditional or unconventional income-generating activities. However, it also underscored the importance of proving regularity, continuity, and a profit motive to meet the standard.

If your facts don't measure up and you don't have a profit intent, then the IRS could claim that you're engaged in a hobby activity. That determination is also fact-based and if you fail that test, losses are only deductible to the extent of your gross income from the activity and are also miscellaneous itemized deductions which are currently suspended through 2025. You'll also lose the ability to claim expense method depreciation as well as the qualified business income deduction. But at least the activity's income won't trigger self-employment tax.

If you think your activity's status as a trade or business is unclear, seek guidance from a tax professional. The bottom-line tax result can be significant.

Income Tax Basis

Income tax basis is a key concept that can have a big impact on your income. It's the measure of your investment in property for tax purposes, and it's determined in various ways depending on how you acquired an asset.

Your income tax basis in an asset is what determines how much gain or loss you incur when you dispose of the asset or when you are computing depreciation on the asset. The starting point for determining basis is tied to how you acquired the asset. Most often, your basis in an asset is what you paid for it plus any debt obligations and any additional property or services that were included in the acquisition. But, if you received an asset by gift, your basis is the donor's basis increased by any gift tax that the donor paid on the transfer. For an inherited asset, you receive a basis equal to the fair market value at the time of the decedent's death if the asset's value was included in the decedent's gross estate at death.

During your period of ownership of an asset, your basis will adjust upward for improvements to the asset and downward for depreciation allowed.

Make sure to keep good records on basis. If you don't the IRS can assume the basis is zero or you may lose certain deductions or incur more taxable gain. For example, in *Baird v. Comm'r., T.C. 1984-401***,** the taxpayer sold stock but could not substantiate the basis of the shares sold. Without proper documentation, the Tax Court ruled in favor of the IRS, assigning a zero basis to the stock and increasing the taxable gain. Also, in *Estate of Smith v. Comm'r., T.C. Memo. 2000-248*, the taxpayer's estate tried to establish a higher basis for property that had appreciated in value. Due to a lack of credible evidence and supporting documentation, the court upheld the IRS's valuation. Similarly, in *Foy v. Comm'r., T.C. Memo. 2020-111,* the taxpayer tried to deduct losses from a partnership investment. However, the taxpayer failed to provide sufficient evidence of tax basis in the partnership interest. As a result, the court disallowed the deductions.

These cases highlight the importance of maintaining proper records, such as receipts, purchase agreements, and other documentation, to establish your basis in property, stock, or investments.

While you might be allowed to estimate your basis under a special rule, but that won't likely produce as good an outcome as if you kept accurate records.

What is a Cropper and why Does it Matter?

In the agricultural sector, agreements other than leases are sometimes utilized which authorize a person to come onto the farm to conduct farming operations. One such person might be a "cropper." What is a cropper and what legal rules apply?

A cropper occupies a legal position somewhere between the status of a tenant and an employee or independent contractor. A person is likely to be a cropper when the landowner supplies land and all the inputs, controls the operation of the farm and pays a portion of the crop to the person who actually raises and harvests the crop. A cropper, unlike a tenant who has a possessory interest in the leased premises and control over the farming operation, only has permission to be on the land. A cropper does not have any legally enforceable interest in the crops and has only a contract right to be compensated in-kind for their labor. While a tenant is entitled to proper notice of lease termination, a cropper has no interest in real property to terminate. An employee might be covered by a state worker's compensation law, but a cropper would not be.

Note: When there's a question about legal status, courts will look at any written agreements, the conduct of the parties and the type of farming operation involved. No single factor controls. Make sure you understand the difference between a tenant, employee and cropper and why it matters.

Like-Kind Exchange of Farmland

If you are considering selling your farmland you can defer any gain on sale into other real estate by using the like-kind exchange rules. But the rules can be tricky.

A tax-deferred like-kind exchange of farmland is fairly simple if bare land is exchanged for bare land of comparable value. But many farm tracts have improvements or depreciable real property. While the transaction can still qualify as a like-kind exchange, to completely defer the gain the replacement property must contain improvements or depreciable real property of equal or greater value. If not, you could trigger ordinary income.

But, even if your transaction triggers ordinary income, you still might come out ok. If the transaction occurs in a state that follows federal law on bonus depreciation or doesn't have an income tax, you might get a better tax result than deferring the gain. This is because the gain is not subject to self-employment tax, and the purchased improvements can be fully depreciated and reduce self-employment tax. But, if you trade land containing improvements or depreciable real property and acquire bare farmland, the gain will be fully realized and cannot be deferred, and it will be taxed as ordinary income.

As you can see, a like-kind exchange of farmland can be quite complicated. And this just scratches the surface. Make sure to get good tax advice for your situation.

Conclusion

These were just a few random thoughts reflecting questions that I have received in the past week. Of course, the discussion here simply scratches the surface. But maybe it sheds some light for a matter that you're dealing with.