

ALTB 04-08 CHARITABLE CONTRIBUTIONS OF COMMODITIES

Abstract

For some farmers, making a charitable contribution in kind, rather than cash can increase the tax benefit of the gift. The tax consequences of the gift differs depending on whether the donor is an active farmer or a landlord.

Basic Rules

For gifts by farm operators and materially participating landlords, the gifts of crops, livestock, and other items of inventory do not trigger gain on contribution to a charity. Instead, the contribution is limited to the donor's income tax basis of the grain and other "ordinary income property." For charitable gifts of grain or raised livestock, the costs of production are deductible as trade or business expenses under IRC §162. That is the result regardless of whether the contribution occurs in the year of production or a later year.

This can result in a substantial tax advantage to a farm operator. Since the production costs of the grain are deducted on Schedule F, they reduce both taxable and self-employment income. In addition, many farmers do not have enough deductions to make itemizing personal deductions advantageous. In such cases, they receive no deduction for the contribution.

Example 1. In 2003, Amanda Smith, a farm operator, donated 1,000 bushels of soybeans to her church. The donation represented the production from 15 acres. Amanda's cost of production was \$4,000, and the FMV at the time of the donation was \$5,000. For 2003, Amanda was on the cash method of accounting.

Amanda will deduct the \$4,000 of production expense on her 2003 Schedule F. She will not report any income from the gift nor will she deduct any charitable contribution. Assuming Amanda is married, does not have enough itemized deductions to exceed her standard deduction, is in a 25% federal income tax bracket, and a 3% state income tax bracket, her tax savings is \$2,007 more than selling the beans and making a cash donation of \$5,000 to her church.

Result. IRC §170 allows a deduction of the lesser of FMV or basis in property given to a charitable organization or to a state government or subdivision of a state government if the gift was for a public purpose. Because Amanda does not have a basis in the grain, she is not entitled to a charitable deduction. However, Amanda is allowed to claim the \$4,000 of production expenses on her Schedule F as an IRC §162 deduction.

Had Amanda been able to claim a charitable deduction, she would be required to file a Form 8283 for any noncash charitable deduction exceeding \$500. In that event, the charity must complete a Form 8282 to report the later sale of the commodity.

Note. The IRS will be able to compare the actual sale price of a noncash contribution with the value the taxpayer reported on Form 8283.

Gifts of grain, livestock, or other items of inventory to noncharitable donees, family members for example, made in the year of production require that production expenses associated with the gift be reduced in terms of deductibility.

Gifts by Landlords

Early Thinking

Beginning in the 1940s, the IRS initially took the position, via the assignment of income doctrine, that a farmer's gift of commodities to a charity caused the FMV of the commodities to be included in the farmer's gross income. As to the timing of reporting the income, in Rev. Rul. 63-66, 1963-1 C.B. 13, the IRS ruled that when a taxpayer makes a gift of crop shares, the taxpayer must include in gross income the amounts received by the donee for the crop shares **in the taxable year in which the donee reduces the crop shares to money or the equivalent of money**. The holding was based on *Helvering*, where the Supreme Court held that if a donor makes a gift of unrealized income, the donor must recognize income at the time the donor would have realized it (upon receipt) had the donor not given the item of unrealized income away.

Treasury Regulations

The treasury regulations grant a special privilege to sharecrop landlords of deferring recognition of the rental income until the sharecrop amounts are converted to money or its equivalent. For instance, Treas. Reg. §§1.61-4(a) and (b) states, "Crop shares (whether or not considered rent under State law) shall be included in gross income as of the year in which the crop shares are reduced to money or the equivalent of money."

Note. The passage in the regulations is worded the same for farmers on either the cash or accrual methods of accounting, and is viewed as a rule of administrative convenience made necessary by the absence of cash with which to pay the tax before a sale.

However, **when crop shares are donated to charity**, the continuation of the deferral privilege does not serve the purpose of providing cash with which to pay the landlord's tax obligation. It is the donee, not the landlord that will eventually convert the crops to cash. Consequently, there is no reason to continue the preferential treatment accorded crop shares if they are donated to charity.

Change in IRS Position

In Rev. Rul. 75-11, 1975-1 C.B. 27, a farmer-landlord (who filed on the calendar-year basis) donated crop shares received by him as rent to a charity. The following year, the charity sold the crop share for cash. The IRS noted that the farmer had made a gift of realized income, which by virtue of administrative convenience he had not yet been required to recognize. Since it was the charity that converted the crops to cash, the deferral privilege was no longer necessary, and the farmer had to recognize rental income in an amount equal to the FMV of the crop shares as of the time of contribution to the charity. The IRS also ruled that the farmer-landlord would be treated as having made simultaneously a charitable contribution in the same amount.

In the ruling, the IRS also dealt with the issue of a farmer-landlord that uses crop share rents as feed in the farming operation. The IRS viewed the feeding of crop share rents as the equivalent of converting the crop share amounts into cash since the farmer would not have to procure feed from other sources. Accordingly, the IRS ruled that if crop share rents are received in one taxable year and fed to livestock in another taxable year, the landlord must include in income an amount equal to the FMV of the share rents at the

time the crop share rents are fed to livestock. An offsetting deduction under IRC §162 is available at the same time.

Note. Although an offsetting feed deduction is available, including share rents in income is important for purposes of determining net income from self-employment under the optional gross income method and other provisions based on the taxpayer's gross income.

Relevant Caselaw

The courts have generally upheld the IRS position (set forth in Rev. Rul 75-11) on the contribution of commodities to landlords as triggering gain to the landlord on transfer of the commodities to the charity. Unfortunately, the courts have not drawn any distinction as to whether the landlord was a materially participating or nonmaterially participating landlord.

In *Tatum*, the taxpayer was a crop-share landlord who shared in fertilizer and insecticide costs and "materially planned the amount and location of crops and the application of fertilizer, insecticide, and water." The tenant performed all the labor and paid all other expenses. The taxpayer made donations of crops to charities using negotiable warehouse receipts and "cotton classing cards." The taxpayer did not include in income the value of the crops donated, but claimed a charitable deduction for the amounts received by the charitable donees on sale of the crops. The court held that crop shares are potential income assets, not property, and that a landlord may not avoid taxation by assigning rights to the income prior to the reduction of crop shares to money or its equivalent.

Observation. The court noted if the donation had been made by a farmer who was not a landlord, the donation would have been considered an assignment of appreciated property which would shift the tax to the donee.

Note. Negotiable warehouse receipts are viewed by the IRS to be the equivalent of cash.

Nonmaterial and Material Participation Landlords

The cases are not clear on whether the landlords involved were materially participating or nonmaterially participating under the lease agreement. But, the *Tatum* court did refer to *Davison*, which stands for the proposition that share rents under a material participation lease are treated the same as crops of a farmer with the result that growing crops and stored crops produced under such a lease receive a new income tax basis at death. Upon donation of farm products of a farmer to a charity, no income is triggered to the farmer.

However, share rents under a nonmaterial participation lease that are gifted to a charitable organization should be characterized as crop rentals. That would make them taxable to the donor on transfer to the charity.

Note. If crop shares are true rents, the income is recognized to the donor and the donor has a charitable deduction in the same amount. If the crop shares are not rents, the regular rules of IRC §170(e) apply and there is no income recognized, but the charitable deduction is limited to basis, which is ordinarily zero.

Observation. For farm clients interested in donating crop share rents to charity, a written lease agreement clearly specifying the roles of the landlord and tenant will aid in the proper determination of the tax treatment of donated amount.