Gifts of Grain and Other Farm Commodities

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GIFTS OF GRAIN AND OTHER FARM COMMODITIES

— by Neil E. Harl *

The sale of assets held by the taxpayer primarily for sale to customers in the ordinary course of business (such as grain or market livestock) usually produces ordinary income.1 That rule has encouraged gifts of grain and other farm commodities to spouses, children, grandchildren or other family members who are not considered to be holding the gift property for sale to customers. The outcome is capital asset treatment for gains and avoidance of liability for self-employment tax.2

Adjustment to inventory

For a gift of grain, livestock or other items of inventory, it has generally been assumed that gifts made after the year of production would not require that production expenses associated with the gift be reduced in terms of deductibility.3 As stated in Rev. Rul. 55-138,4 which focused on an accrual basis taxpayer —

"There must be an adjustment to inventory effecting the removal of the donated asset and the costs pertaining thereto from the opening inventory in the year of the gift. Items of cost of the current year applicable to such property are not deductible by the donor, and similar items which have been deducted in prior years must be removed from the amount of the contribution in order to avoid a double deduction." (Emphasis added.)

A similar position was taken in Rev. Rul. 55-5315 which held that items of cost of donated assets were not deductible in the year of gift or any subsequent year. The ruling noted that, for accrual basis taxpayers, there must be an adjustment to opening inventory in the year of the gift or any subsequent year. The ruling noted that, for accrual basis taxpayers, there must be an adjustment to opening inventory in the year of the gift effecting the removal of the cost or basis of the donated asset. But costs of production deducted prior to the year of the gift need not be reported back into income. Therefore, a strong motivation has existed to delay the gift of grain held for sale until the year following the year of production.

For gifts of grain after the year of production, the costs of production (seed, fertilizer, chemicals, depreciation on equipment and other deductible items) need not be reported into income, the gift ordinarily has a zero income tax basis and the full amount of the sales price is considered a capital gain to the recipient.

Gifts to spouse

Recent private letter rulings6 have challenged gifts of grain to a spouse where the obvious intent was to reduce self-employment tax for the spouse involved in production. In a 1991 ruling, the Internal Revenue Service held that transfers of soybeans from husband to wife as "a reward for the companionship and patience with the stressful lifestyle of farming" were ineffective to avoid self-employment tax on the grounds that — (1) there was no intent to make a gift, (2) it was questionable whether the husband completely divested himself of title, dominion and control over the soybeans, (3) it was not clear whether the gift was of soybeans or of a warehouse receipt and (4) the transaction lacked economic substance or independent significance apart from tax avoidance.7

It is clear that gifts of grain and other farm commodities to a spouse (or other family members) will be scrutinized carefully. To be effective, the donor should manifest a clear intent to make a gift, the donee should assert dominion and control over the commodity and the gift should be of the actual commodity, not of warehouse receipts. Moreover, after the gift to the donee, the donee should bear the risk of loss for the commodity, be responsible for storage charges and carry insurance on the commodity. Indeed, the donor should have no contact with the

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commodity and should not be responsible for its sale or in any way be connected with its sale.

Even with those steps taken, gifts to spouses or other close family members may be challenged if the principal purpose appears to be avoidance of self-employment tax. A reason for the gift other than minimizing self-employment tax is helpful.

FOOTNOTES

1 See I.R.C. § 1221(1). See generally 4 Harl, Agricultural Law § 27.02 (1993).
2 See I.R.C. § 1402.
4 1955-1 C.B. 223.
5 1955-2 C.B. 520.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

COLOR OF TITLE. The parties’ lands were separated by a river. The defendant’s predecessor in title constructed a fence on the defendant’s property in the 1930’s which ran over a hill some distance from the river. The disputed land was the strip between the fence and the river on the defendant’s side of the river. The defendant’s deed named the river as the defendant’s boundary but the plaintiff’s deed listed the “hill on the other side” of the river as its boundary. The plaintiffs used the disputed land to graze cattle. The plaintiffs produced evidence that the community considered the plaintiff’s land to run to the fence on the other side of the river. Although the various deeds were not consistent, the court upheld the jury verdict that the plaintiff acquired the land by adverse possession. The court held that the deed description of the land boundary as the “hill on the other side” was sufficient color of title to support adverse possession and that the plaintiff’s grazing of cattle was sufficient hostile possession to support adverse possession. Quarles v. Arcega, 841 P.2d 550 (N.M. Ct. App. 1992).

HOSTILE POSSESSION. The defendant’s predecessors in interest purchased 90 acres of land and leased 14,000 contiguous acres from the plaintiff’s predecessor in interest. The parties intended that the 90 acres included a parcel known as Solo Springs, but that parcel was actually included in the legal description of the leased portion. The defendant purchased Solo Springs from the purchaser, based on the purchaser’s belief that the parcel was owned by the purchaser. The defendant built a house and other improvements on the parcel. The defendant discovered the error in 1973 and 1978 after having a survey performed. In 1979, the plaintiff purchased 10,000 acres from the owner of the leased acres and Solo Springs was included in the legal description of the purchased acres. After the defendant requested a quitclaim deed from the plaintiff based on adverse possession of Solo Springs, the plaintiff brought the present forcible entry and detainer action. The court upheld the trial court’s judgment for the defendant. The court held that the prohibition of adverse possession by a tenant against a landlord did not apply because neither the defendant nor the predecessor in interest believed that they leased the property from the plaintiff or the plaintiff’s predecessor in interest. The court also held that the improvements made by the defendant were sufficient evidence and notice of hostile possession of the disputed land. The court rejected the plaintiff’s defense that neither it nor its predecessor in interest knew about the defendant’s improvements. Lewis v. Pleasant Country, Ltd., 840 P.2d 1051 (Ariz. Ct. App. 1992).

OPEN POSSESSION. The plaintiff claimed title to the disputed land by adverse possession under color of deed. The plaintiff provided evidence of rotational rice farming whereby the land was cropped one year and left fallow for two or three years. For several years, no rice was planted but the land was used for grazing, although no fence was erected. The court held that the plaintiff’s possession was not sufficiently visible to support title by adverse possession because the land became sufficiently overgrown so as to erase evidence of rice cropping. In addition, the use of the land for grazing was not sufficient because the grazing was not continuous and no fence was erected as evidence of hostile use. Parker v. McGinnes, 842 S.W.2d 357 (Tex. Ct. App. 1992).

BANKRUPTCY

GENERAL

AVOIDABLE TRANSFERS. A third party had obtained the debtor’s house by a tax sale in 1989. The debtor’s redemption rights expired in June 1992 and the third party obtained a tax deed on the property. The debtor filed for bankruptcy in August 1992 and sought to avoid the tax deed as a fraudulent conveyance under Section 548(a). The third party sought to dismiss the action because the transfer occurred more than one year before the bankruptcy petition. The court denied the third party’s motion and held that the transfer occurred when the