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Additional Guidance on the 30 Percent Depreciation Allowance

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In the News

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ADDITIONAL GUIDANCE ON THE 30 PERCENT DEPRECIATION ALLOWANCE

— by Neil E. Harl*

The legislation signed into law on March 9, 2002, the Job Creation and Worker Assistance Act of 2002,¹ contained a highly important provision for farm and ranch (and other) taxpayers—an additional depreciation allowance of 30 percent of the adjusted income tax basis of qualifying property.² In late April, the Internal Revenue Service issued needed guidance on how the depreciation allowance can be claimed and what should be done if the taxpayer does not wish to claim the 30 percent allowance.³

General rules

Under *Rev. Proc. 2002-33*,⁴ the recently-issued guidance, a taxpayer may make an election to *not* deduct the 30 percent depreciation allowance.⁵ In the event that election is made (not to claim the 30 percent amount), *the property is subject to AMT depreciation adjustments for its depreciation life*.⁶ It is important to note that if an election is *not* made to not deduct the 30 percent depreciation allowance, *it is assumed the 30 percent amount is claimed*.⁷ Thus, the 30 percent amount is considered “allowed” or “allowable.”⁸

In general, an election not to deduct the 30 percent depreciation allowance must be made by the due date (including extensions) of the federal income tax return for the year property is placed in service.⁹ An automatic extension of six months from the due date of the return (excluding extensions) is allowed for the election not to deduct the 30 percent depreciation amount if the return was timely filed.¹⁰

Taxpayers who did not claim the allowance on the 2001 return—and want to claim the amount

Under the statute, for property to be eligible for the 30 percent allowance, the assets had to be acquired after September 10, 2001 (with no written contract to acquire the property before September 11, 2001) and before September 11, 2004, and placed in service before January 1, 2005 (except for certain property with longer production periods).¹¹ That means many farm and ranch taxpayers had filed their 2001 returns before the statute was signed into law.¹²

So how can taxpayers make the election to claim the 30 percent allowance for 2001? The recent guidance states that if an income tax return was filed before June 1, 2002, and did not claim the additional 30 percent depreciation allowance, if the taxpayer wishes to claim the depreciation amount, the taxpayer can either

- File an amended return on or before the due date (excluding extensions) of the return *for the next succeeding taxable year* (that would be the due date for the 2002 return in

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most instances),¹³ in which case the amended return is to include the statement, "Filed Pursuant to Rev. Proc. 2002-33" at the top of the amended return,¹⁴ or

- File a Form 3115, Application for Change in Accounting Method, with the taxpayer's federal tax return *for the next succeeding taxable year* (again, that would be the 2002 return in most instances).¹⁵ In that case, the Form 3115 is to be filed in accordance with the automatic change in method of accounting.¹⁶ The Form 3115 should include the statement, "Automatic Change Filed under Rev. Proc. 2002-33."¹⁷ The deduction is claimed entirely in the year of change.¹⁸

Taxpayers who did not claim the allowance on the 2001 return and do not want to claim the amount

For returns filed before June 1, 2002, the guidance states that the election not to deduct the 30 percent depreciation amount is considered made if

- the taxpayer made the election by the due date of the return or within the six-months extension as required by the Form 4562 instructions (the Form 4562 instructions require a statement indicating the class of property for which the taxpayer is electing not to deduct the 30 percent depreciation allowance), or

- made the election by the due date of the return or within the six-month extension and attached a statement to the effect that the taxpayer is not deducting the 30 percent depreciation.¹⁹ A "deemed election" applies if the taxpayer did not claim the 30 percent depreciation deduction on the return and does not file an amended return to claim the 30 percent depreciation allowance.²⁰

Therefore, for returns filed before June 1, 2002, the taxpayer need do nothing if—(1) the 30 percent allowance was not claimed and (2) the taxpayer does not want to claim the amount.

Returns filed on or after June 1, 2002

For returns filed on or after June 1, 2002, taxpayers wanting to claim the 30 percent allowance do so on Form 4562. For taxpayers *not* wanting to claim the 30 percent depreciation deduction, an election must be made not to deduct the depreciation as required by the Form 4562 instructions (attach a statement to the return indicating the class of property for which the taxpayer is electing not to deduct the 30 percent depreciation amount).²¹ If the original return is timely filed, a taxpayer apparently is allowed an automatic extension of six months from the original due date to make the election (not to deduct the 30 percent depreciation allowance).²²

Thus, for returns filed on or after June 1, 2002, the taxpayer must either

- Claim the 30 percent depreciation allowance on Form 4562, or
- Attach a statement to the income tax return that the taxpayer is electing not to claim the 30 percent depreciation allowance.

Revoking elections not to deduct

An election not to deduct the 30 percent depreciation allowance for a class of property is revocable only with the consent of the Commissioner.²³

Final note

Remember, the 30 percent depreciation allowance is claimed after expense method depreciation has been claimed.²⁴

FOOTNOTES

- 1 Pub. L. No. 107-147, 116 Stat. 21 (2002). See Harl, "Additional Depreciation Allowance and Loss Carrybacks," 13 *Agric. L. Dig.* 49 (2002).
- 2 I.R.C. § 168(k)(1), added by Pub. L. 107-147, Sec. 101(a), 116 Stat. 21 (2002). See IR 2002-37 (Form 4562 and Form 2106 revised to include provisions of JCWAA of 2002).
- 3 Rev. Proc. 2002-33, I.R.B. 2002-___.
- 4 I.R.B. 2002-___.
- 5 *Id.*
- 6 *Id.*, Sec. 3.01.
- 7 *Id.*, Sec. 3.05.
- 8 See, e.g., *Jakobowski v. United States*, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,594 (10th Cir. 2001) (unclaimed depreciation (over 14-years) had to reduce basis; sale produced additional gain).
- 9 Rev. Proc. 2002-33, Sec. 3.03, I.R.B. 2002-___.
- 10 *Id.*, Sec. 3.03(2)(a).
- 11 I.R.C. § 168(k)(2)(A)(ii).
- 12 See n. 1 *supra* and accompanying text.
- 13 Rev. Proc. 2002-33, Sec. 4.01(1), I.R.B. 2002-___.
- 14 *Id.*
- 15 *Id.*, Sec. 4.01(2).
- 16 See Rev. Proc. 2002-9, I.R.B. 2002-3, 327, as modified by Rev. Proc. 2002-19, I.R.B. 2002-13, 696, and as modified and clarified by Ann. 2002-17, I.R.B. 2002-8, 561.
- 17 *Id.*
- 18 Rev. Proc. 2002-19, I.R.B. 2002-13, 696, amending Rev. Proc. 2002-9, I.R.B. 2002-3, 327.
- 19 Rev. Proc. 2002-33, Sec. 4.02(1), I.R.B. 2002-___.
- 20 *Id.*, Sec. 4.02(2).
- 21 *Id.*, Sec. 3.03(3)(a).
- 22 Treas. Reg. § 301.9100-2(b).
- 23 Rev. Proc. 2002-33, Sec. 3.04, I.R.B. 2002-___.
- 24 Joint Committee on Taxation, Technical Explanation of the Job Creation and Worker Assistance Act of 2002, JCX-12.02, Sec. 1 (2002).

FARM ESTATE & BUSINESS PLANNING

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By Neil E. Harl

The 15th Edition of this popular softcover book provides lay level guidance on farm estate and business planning concepts and planning pointers for farmers and ranchers. The book is updated to 2001 and contains the latest on the effects of the Economic Growth and Tax Relief Reconciliation Act of 2001. The book may be ordered by contacting Doane Agricultural Services, 11701 Borman Dr., Suite 100, St. Louis, MO 63146. Ph. 1-800-535-2342.

THE PARSONAGE EXCLUSION - FIRST AMENDMENT CONCERNS?

— by Roger A. McEowen*

Overview

On May 16, 2000, the United States Tax Court, in *Warren v. Comm'r.*,¹ held that the parsonage exclusion for a minister² is the actual amount used to provide a home, not the fair market rental value of the home. The petitioner, a “minister of the gospel” with significant outside income, and his wife purchased a home in 1992 for \$360,000. The fair market rental value of the home was \$58,061 in 1993, \$58,004 in 1994, and \$59,479 in 1995. As compensation, the petitioner’s church paid the petitioner \$77,663, \$86,175 and \$99,653 for the years 1993, 1994 and 1995, respectively. For some of the years in question, the entire amount of compensation was designated as a housing allowance and entirely excluded from the petitioner’s gross income.

The petitioner spent a total of \$77,663 in 1993, \$76,309 in 1994 and \$84,278 in 1995 for home expenditures including the mortgage, utilities, furnishings, landscaping, repairs, maintenance, taxes and insurance. Based on these expenditures, the petitioner excluded all of the 1993 compensation and reported \$9,866 in 1994 and \$19,654 in 1995. The IRS, in accordance with Rev. Rul. 71-280,³ determined that the petitioner’s exclusion was limited to the fair market rental value of the home and increased the petitioner’s gross income by the difference between the compensation paid and the fair market rental value of the home for 1993, 1994 and 1995.

The I.R.C. § 107 Issue

The issue facing the Tax Court was whether the exclusion from gross income provided by I.R.C. § 107 was limited, as the IRS asserted, to the fair rental value of the “parsonage.”

I.R.C. § 107 provides:

“In the case of a minister of the gospel, gross income does not include-

1. the rental value of a home furnished to him as part of his compensation or
2. the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home.”

The Tax Court, disagreeing with the contention of the IRS that the Congress, in enacting I.R.C. § 107, intended to impose a rental value limit on the exclusion, ruled that the exclusion is the amount actually used to provide a home not limited by the fair market rental value of the home.⁴ The IRS interpreted the exclusion to be the lesser of the amount used to provide a home or the fair market rental value of the home, and argued that permitting a greater exclusion would be contrary to both the “rental” language in the Code and the legislative history of concern for equality among ministers.⁵ The Tax Court noted that although I.R.C. § 107(1) limits the exclusion to the rental value of a home furnished as part of a minister’s compensation, there is no mention of rental value in I.R.C. § 107(2) or the

regulations.⁶ The dissent stressed that the majority opinion ignored the modifier “rental” in I.R.C. § 107(2).⁷ The dissent concluded that the Congress intended that the exclusion be correlated to rental value, and that the majority’s opinion placed ministers or churches utilizing I.R.C. § 107(2) rather than I.R.C. § 107(1) in a more favorable position.⁸

The IRS appealed the Tax Court’s opinion to the U.S. Circuit Court of Appeals for the Ninth Circuit.

The Constitutional Issue

At the Tax Court level, neither the IRS nor the Tax Court raised a constitutional question. Indeed, at the Tax Court level, the issue was framed solely as a matter of statutory construction – whether a clergyman receiving a cash housing allowance from a religious employer can exclude from gross income the full amount of the allowance spent on housing or can only exclude up to the rental value of the home. On appeal, however, the Ninth Circuit asked the parties whether either wanted to frame the issue in constitutional terms.⁹ Both the IRS and the petitioner declined, but the three-judge panel hearing the case, over strong dissent, ordered the parties to brief both the constitutionality of I.R.C. § 107(2) and the propriety of the court reaching the issue on its own initiative.¹⁰ The panel, in ordering the briefing of the constitutional issue, specifically mentioned as relevant to the constitutional status of I.R.C. § 107(2)¹¹ the opinion of the United States Supreme Court in *Texas Monthly, Inc. v. Bullock*,¹² which struck on Establishment Clause grounds a Texas sales tax exemption limited to religious literature.¹³ However, the court failed to cite a 1970 Supreme Court opinion that focused more on Free Exercise concerns and suggested that tax provisions like I.R.C. § 107 properly accommodate the autonomy of sectarian entities and persons.¹⁴ Briefs on the matter were due on May 3, 2002.

The primary concern of the Ninth Circuit panel seems to be that I.R.C. § 107 provides a more generous rule for exclusion of employer-provided housing for “ministers of the gospel” than is provided under I.R.C. § 119 for those in secular employment. Section 119 excludes from an employee’s income employer-provided lodging, but only if the lodging is on the employer’s premises, is provided for the employer’s “convenience,” is required as a condition of employment, and is furnished in-kind rather than through a cash allowance. Section 119 applies irrespective of whether the employer is a secular organization or a sectarian entity. Section 107, on the other hand, is limited to “ministers of the gospel.” In addition, I.R.C. § 107 contains no convenience-of-the-employer test, does not require that the excluded housing be located on the employer’s premise or be a condition of employment, and extends tax-free treatment to cash allowances. Thus, from a constitutional standpoint, the potentially controversial situations are those arrangements by which religious employers provide housing assistance to clergy that fail the I.R.C. § 119 tests for excludability, but satisfy the more lenient standard of I.R.C. § 107. That is the precise situation presented in *Warren*.¹⁵

In the event the constitutional issue is addressed by the court, one possible view is that I.R.C. § 107 actually helps disentangle the government from sectarian affairs by not requiring the IRS to undertake the detailed analysis that would be necessary if the minister’s lodging were provided pursuant to I.R.C. § 119. That approach is consistent with the rationale of *Walz*¹⁶ and the

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dissent in *Texas Monthly*,¹⁷ and suggests that I.R.C. § 107 is constitutional. Conversely, another view is that tax benefits extended to religious institutions are constitutional only if they are provided equally to nonreligious activities in accordance with a secular purpose. Under this view, I.R.C. § 107 is not constitutional, but I.R.C. § 119 is not at risk because it has broad application and is not designed to assist religion.

Possible Outcomes

In the event that the Ninth Circuit decides to rule on the constitutional matter and finds I.R.C. § 107 unconstitutional, the opinion would only be binding within the jurisdiction of the Ninth Circuit.¹⁸ The case would then proceed to the United States Supreme Court where, given the present make-up of the Court, it is unlikely that the Court (if it agrees to hear the case) would find the provision unconstitutional.¹⁹

Even if I.R.C. § 107 were ultimately held unconstitutional, religious employers would still be able to provide tax-free lodging to ministers pursuant to the more restrictive rules of I.R.C. § 119 – the lodging would have to be on the employer's premises, be provided for the employer's "convenience," be required as a condition of employment, and be furnished in-kind rather than through a cash allowance. In that setting, the Congress would likely act to preserve the tax preference for ministers.

Of course, the Ninth Circuit could refrain from ruling on the constitutional issue, but reverse the Tax Court's opinion with the exclusion being limited to the rental value of the "parsonage" – the historic IRS position.²⁰

Congressional Reaction

The *Warren*²¹ case and the possibility of a federal court holding I.R.C. section 107 unconstitutional have moved the Congress. On April 16, 2002, the House passed legislation that would amend I.R.C. section 107(2) to provide specifically that the parsonage allowance is limited to an amount that "does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities."²² A similar bill was introduced in the Senate on April 18, 2002²³ and cleared the Senate on May 2, 2002. Interestingly, neither the House nor Senate bills, if enacted into law, will have any effect on the *Warren*²⁴ litigation and, thus, neither bill will prevent the Ninth Circuit from potentially addressing the constitutional issue. Both bills apply prospectively to tax years after 2001, and do not apply to 1993-1995, the years at issue in *Warren*.²⁵

Final Point

The *Warren* case²⁶ would never have arisen had the petitioner followed the long-standing IRS position²⁷ and claimed as a housing exclusion only the amount representing the rental value of the "parsonage." Obviously, the petitioner drew the attention of the IRS by claiming (in some years) his *entire* compensation as a non-taxable housing allowance. The case certainly illustrates the perils of taking an overly aggressive position on the tax return.

It is true in agriculture and often true in tax law – pigs get slaughtered. Unwittingly, Rev. Warren (whose gross income for the years in issue placed him in the top two percent of all individual taxpayers in the United States and who can certainly provide his own housing without the benefit of I.R.C. § 107) may have taken all "ministers of the gospel" (many of whom

desperately depend on the I.R.C. § 107 exclusion) to the tax slaughterhouse with him.

FOOTNOTES

¹ 114 T.C. 343 (2000).

² I.R.C. § 107.

³ 1971-2 C.B. 92 (maximum I.R.C. § 107 exclusion capped at the fair rental value of residence).

⁴ 114 T.C. 343 (2000).

⁵ *Id.*

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ *Warren v. Comm'r.*, No. 00-71217, 2002 U.S. App. LEXIS 3420 (9th Cir. Mar. 5, 2002).

¹⁰ *Id.* The court also appointed Prof. Erwin Chemerinsky of the University of Southern California Law School to act as amicus curiae and brief both the constitutional issue and whether the court has the authority to raise the issue on its own.

¹¹ It is not possible for the court to find I.R.C. § 107(2) unconstitutional, and uphold the balance of the provision. Either all of I.R.C. § 107 is unconstitutional or the entire provision is constitutional.

¹² 489 U.S. 1 (1989).

¹³ *Id.* There was no majority opinion in *Texas Monthly*. Rather, a plurality of three justices held that the state sales tax exemption at issue was a religious subsidy that entangled the state with religion in determining the bounds of the exemption. Three justices wrote a dissenting opinion (authored by Scalia), and the three swing justices who made up the plurality opinion issued two separate concurring opinions.

¹⁴ *Walz v. Tax Commission*, 397 U.S. 664 (1970) (tax exemptions and exclusions for religious entities do not subsidize religious bodies, but recognize their freedom and autonomy).

¹⁵ 114 T.C. 343 (2000). An important point that should not be overlooked is that the Ninth Circuit, even as it raised the issue of the constitutionality of I.R.C. § 107(2), also expressed reservations about the propriety of a court considering an issue advanced by neither litigant and indicated that it may, after all, decline to resolve the constitutional controversy. Thus, the matter may be purely an academic exercise.

¹⁶ 397 U.S. 664 (1970).

¹⁷ 489 U.S. 1 (1989).

¹⁸ The Ninth Circuit includes Alaska, Arizona, California, Idaho, Hawaii, Montana, Nevada, Oregon, Washington, Guam and the Northern Mariana Islands.

¹⁹ Of the justices that authored the plurality opinion in *Texas Monthly*, only Justice Stevens presently remains on the court. Justice O'Connor also remains on the Court and concurred in the plurality opinion. All three of the dissenting justices – Scalia, Rehnquist and Kennedy, remain on the Court.

²⁰ Rev. Rul. 71-280, 1971-2 C.B. 92.

²¹ See n. 1 *supra*.

²² H.R. 4156, the Clergy Housing Allowance Clarification Act of 2002. The legislation passed 408-0, and would apply to

taxable years beginning after December 31, 2001. The bill is estimated to raise \$33 million in revenue over the next decade.

²³ S. 2200, 107th Cong., 1st Sess. The legislation would apply to tax years beginning after December 31, 2001.

²⁴ 114 T.C. 343 (2000).

²⁵ *Id.* Both bills provide that “notwithstanding any prior regulation, revenue ruling, or other guidance issued by the Internal Revenue Service, no person shall be subject to the limitations added... before January 1, 2002.” The most likely

interpretation of that language is that it does not render the *Warren* litigation moot. Instead, the Ninth Circuit would have to interpret I.R.C. § 107 without the benefit of Rev. Rul. 71-280, but would not be precluded from reaching the same result.

²⁶ 114 T.C. 343 (2000).

²⁷ Rev. Rul. 71-280, 1971-2 C.B. 92.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

FEDERAL TAX-ALM § 13.03[7].*

DISCHARGE. The debtor had failed to file returns for 1983 through 1986. The IRS made assessments based on substitute returns it created. The debtor made two offers in compromise which were rejected because the debtor had not filed returns. The debtor eventually filed the returns, claiming less tax due than the amount assessed by the IRS. The debtor sought to discharge the taxes because the returns were filed more than three years before the bankruptcy petition was filed. The court held that the debtor’s returns did not qualify as tax returns under Section 523(a)(1)(B) because the IRS had already created substitute returns and made an assessment and the debtors’ returns were not an honest attempt by the debtor to comply with the filing requirements. *In re Rushing*, 273 B.R. 223 (Bankr. D. Ariz. 2001).

NET OPERATING LOSSES. The debtor owned two S corporations and filed for Chapter 11, with the stock passing to the bankruptcy estate. The corporations had net operating losses for the period between the start of its tax year and the date of the debtor’s bankruptcy petition. The debtor claimed the losses as net operating losses and carried the losses forward to post-bankruptcy tax years. The debtor did not elect to bifurcate the debtor’s tax year in which the petition was filed. In a Chief Counsel Advice letter, the IRS ruled that the debtor could not claim the net operating losses because the losses passed to the bankruptcy estate with the stock. The net operating losses would then be used to decrease the basis of the stock to the extent of discharge of indebtedness which occurred as part of the bankruptcy case. If any net operating losses remained after the basis reduction, they passed to the debtor. After the bankruptcy case closed, the lowered basis of the stock also passed on to the debtor. *CCA Ltr. Rul. 200217003, Dec. 14, 2001.*

FEDERAL AGRICULTURAL PROGRAMS

FOOT AND MOUTH DISEASE. The APHIS has issued proposed regulations amending the indemnity provisions pertaining to the control and eradication of foot-and-mouth disease and other serious diseases, including both cooperative programs and extraordinary emergencies. **67 Fed. Reg. 21933 (May 1, 2002).**

KARNAL BUNT. The APHIS has issued interim regulations amending the Karnal bunt regulations to prohibit grain grown in a regulated area from being used as seed outside the regulated areas. The interim regulations also remove the requirement that wheat seed, durum wheat seed, and triticale seed that originates within a regulated area be treated with a fungicide before it may be planted within a regulated area. **67 Fed. Reg. 21159 (April 30, 2002).**

The APHIS has issued interim regulations amending the Karnal bunt regulations to provide compensation for certain growers and handlers of grain and seed affected by Karnal bunt who are not currently eligible for compensation, and for certain wheat grown outside the regulated area that was commingled with wheat grown in regulated areas in Texas. **67 Fed. Reg. 21561 (May 1, 2002).**

MIGRANT WORKERS. The plaintiffs were migrant and seasonal agricultural laborers who resided in Texas. The plaintiffs were recruited in Texas by a Texas farm-labor contractor hired by the defendant, a New York dairy, for work in New York. The employment contracts contained a provision that jurisdiction over the contracts was in New York. The defendant argued that the Texas District Court lacked personal jurisdiction over the defendant who had no contacts with the state. The court held that the forum selection clause was unenforceable as contrary to the provisions of MSAWPA which prohibited the waiver of rights granted by MSAWPA. The court also held that the court had personal jurisdiction over the defendant because the defendant had “purposefully directed” its activities at the residents of Texas by hiring the Texas farm-labor contractor to hire residents of Texas.