Agricultural Law Update

VOLUME ONE, NUMBER FOUR, WHOLE NUMBER FOUR — JANUARY 1984

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INSIDE

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- Termination of tenancies by the entirety
- Final regulations for amortization of reforestation expenditures
- More on the impact of the PIK program

"Justice is the ligament which holds civilized beings and civilized nations together."

—*Daniel Webster*

PIK is profit from the land

The bankruptcy court for the district of Colorado has ruled that a PIK payment is covered by a security interest in land aud "the rents, issues, and profits thereof and income therefrom." *In re Preisser* 10 BCD 1306 (D. Col. September 14, 1983). In that case, the debtor asked the court to allow him to assign his PIK benefits to his attorney in payment of fees. The United States objected stating that it had a valid security interest in the benefits by virtue of a deed of trust with the above quoted language. The court agreed with the United States saying that any benefits the debtor receives from the government for the non-production of grain on his land must be construed to be rents or profits from the land.

— *Philip E. Harris*

Deducting interest on deferred federal estate tax

In *Estate of Bailly,* 81 T.C. ___, No. 18 (September 6, 1983) the estate elected installment payment of estate taxes under I.R.C.§ 6166 and wanted to immediately deduct the interest it expected to pay in the future. The court agreed with the I.R.S. that the future interest payments could be deducted only as they were paid. The court stated that no reasonable estimate of the future interest could be made because the interest rates fluctuate and the payment of tax can be accelerated. In a later decision, the court ruled that the entry of the first decision must be postponed until the final installment is due or is paid. The second ruling was necessary because I.R.C. § 6512(a) appears to preclude a refund based on a deduction for interest that accrues after a Tax Court decision becomes final. Estate of Bailly 81 T.C. ____, No. 59.

— *Philip E. Harris*

Useful life for noncorporate lessor rules

The tax court ruled in *Fredericks, et al* 47 CCH Tax Ct Memo 523 (December 5, 1983) that the useful life for use purposes of I.R.C. § 46(e) (3) (B) is the same as the useful life claimed for purposes of depreciation. I.R.C. § (46)(c) (2). The taxpayer was not allowed to claim investment tax credit because the term of the lease equalled the useful life that was claimed for purposes of depreciation.

— *Philip E. Harris*

IRS changes position on special use recapture

In a second major change of interpretation in the special use valuation area in less than a year, the Internal Revenue Service has apparently abandoned the position of disproportionate recapture. In an early 1983 ruling, IRS had changed its position to allow full deductibility of mortgage indebtedness for special use value land.

The change in recapture calculations came in *Ltr. Rul. 8350035* (no date given). In several rulings since 1980 and in numerous audits, the IRS position had been that no recapture because of disposition of only a part of a qualified heir's special use value land, the amount of federal estate tax recaptured was the lesser of the total amount of federal estate tax saved for that qualified heir or the gain on disposition. In *Ltr. Rul. 8215036, January 15, 1982,* IRS outlined its position with an example —

"If the qualified heir received 100 acres with a special use value of $5,000 per acre and the estate tax savings as a result of the 2032A election in the decedent's estate with respect to that interest was $50,000, the recapture tax imposed on the sale of 1 acre of specially valued property would be the lesser of (1) $50,000 (the adjusted tax difference attributable to the heir's interest), or (2) the amount realized on the sale in excess of $5,000."

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IRS CHANGES
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That position meant that disposition of only a relatively small part of the land could lead to recapture of *the entire amount of federal estate tax saved.* In one recent case, sale of 80 acres out of 840 acres inherited triggered recapture of nearly $90,000 of federal estate tax saved.

Now, in *Ltr. Rul. 8350035,* IRS has adopted the position that the amount of federal estate tax recaptured is proportionate to the amount of property transferred outside the family or otherwise ceasing to meet the post-death requirements to avoid recapture. In the ruling, a personal residence was built on two acres of special use land in 1978. The land involved was owned by two qualified heirs, each with an undivided one-half interest. Each undivided half interest in the two acres had a fair market value at death of $2250 with a special use value of $584. All land under special use valuation had a fair market value at death of $704,000 and a special use value of $211,400. The total amount of federal estate tax saved was $127,000.

The formula for recapture used by IRS was —

$$\text{Amount recaptured} = \frac{\$2,250 - \$584}{\$704,000 - \$211,400} \times \$127,000$$

$$= \frac{1,666}{492,600} \times 127,000$$

$$= \$429.52$$

The change of position is expected to meet with widespread approval and squares with what many thought was the correct statutory interpretation.

The major problem with the new interpretation will be in determining the fair market value of the portion disposed of (or otherwise triggering recapture) *as of the date of death.* This could be a substantial problem.

— *Neil E. Harl*

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Request for taxpayer identification numbers and back-up withholding

The legislation repealing mandatory withholding of income tax on dividends and interest, Pub. L. 98-67, added two important features for payors of dividends and interest and patronage dividends. Anyone under a duty to file information returns for dividends and interest, including those buying land on contract from individual sellers, are to — (1) exercise "due diligence" in obtaining taxpayer identification numbers of payees (with mailing by December 31, 1983, on pre-1984 accounts) and (2) commence back-up withholding at a 20 percent rate if any one of four conditions is met. Payors use new Form W-9 to obtain taxpayer identification numbers of payees and to obtain certification from payees that back-up withholding does not apply.

For payments after December 31, 1983, a payor is to initiate back-up withholding if —

- The payee fails to furnish the taxpayer identification number to the payor,
- IRS notifies the payor that the taxpayer identification number furnished by the payee is incorrect,
- IRS has notified the payor that the payee has underreported income tax on interest, dividends or patronage dividends, or
- There has been a "payee certification failure."

In the event the payee fails to respond with a taxpayer identification number, or to give the correct number, the payor must repeat the request each year for the correct number.

Note: back-up withholding applies to payments other than dividends and interest if the payee fails to furnish the taxpayer identification number or the number is incorrect.

— *Neil E. Harl*

Single purpose agricultural structures

In 1978, Congress resolved the controversy over whether confinement livestock facilities were eligible for investment tax credit by authorizing the credit for "single purpose agricultural and horticultural structures." Final regulations have now been issued on the 1978 enactment; several recently published letter rulings add to the guidance on designing facilities to be eligible.

Basic rule

To be eligible for investment tax credit, a single purpose agricultural structure must be "specifically designed, constructed and used for housing, raising and feeding a particular type of livestock and their produce and for housing the equipment (including any replacements) necessary for the housing, raising and feeding of such livestock and their produce."

- The emphasis on "livestock" in the definition has been carried into the regulations. The definition of livestock is that used for determining eligibility for investment tax credit. Thus, horses are not considered to be livestock but poultry are livestock for this purpose. See *Ltr. Rul 8330011,* April 25, 1983 (barn and arena for breeding, raising and training show horses ineligible for investment tax credit.)
- A dairy facility used solely to store milk does not qualify for investment tax credit unless the cows are milked there.
- The regulations permit "ancillary post-production activities" such as "gathering, sorting and loading livestock, plants and mushrooms, and the live offspring and unprocessed produce of livestock." But the regulations do not permit processing activities such as slaughtering or packing meat or marketing activities.
- A structure may be used for storing feed or machinery but more than incidental use for these purposes disqualifies the structure. Storage is presumed to be subordinate if not more than one-third of the structure's total usable volume is devoted to storage.

One type of livestock

The regulations specify that a structure does not qualify for investment tax credit if designed, constructed or used for more than one particular type of livestock. Each species is considered to be a different type except that all species of poultry are considered to be of a single type. Thus, if a confinement facility built for calves on feed is later used for hogs, investment tax credit apparently would be recaptured. With this approach taken in the regulations, it appears to be important to watch hogs following cattle in an otherwise eligible facility.

Required equipment rule

Under the final regulations, a single purpose agricultural structure must house equipment necessary to house, raise and feed livestock. If not, investment tax credit cannot be claimed.

The required equipment must be an integral part of the structure such as equipment necessary to contain the livestock, provide the livestock with water or feed or to control temperature, humidity or lighting.

(continued on page 5)

The impact of the windfall profit tax on royalty owners

by Judon Fambrough, Texas A&M University

In April of 1979, President Carter announced that there would be a gradual phase out of all price controls on domestically produced oil under the authority granted him by the Energy Policy and Conservation Act of 1975. The price phase out was to be completed by September 30, 1981. However, prior to the projected termination date, President Reagan lifted all price controls on January 28, 1981.

To offset any "windfall profit" which might accrue to the oil companies and royalty owners due to the price decontrols, Congress passed the Windfall Profit Tax (WPT). This act imposes an excise, or severance tax, on the price increases of domestically produced crude oil attributable to the Administration's decision to phase out price controls. The tax will remain in effect for ten years and nine months or at least through September, 1990. The tax will be phased out at 3% per month beginning January, 1988 (for 33 months thereafter) or until the reserve revenue target of $227.3 billion is raised, *whichever is later.*

In view of recent record profits by some oil companies, many people heralded the new law as being justified. At the same time, many people did not realize that the tax affected royalty owners just as severely (and in some cases, more adversely) than it does the producers. This fact can be quickly verified by an examination of *Table 1,* a table relating to the respective tax rates on (1) independent producers, (2) integrated producers and (3) royalty owners.

In order to understand *Table 1* and the windfall profit tax, the royalty owner must first grasp the differences in the three tiers (or types) of oil just described. Without going into any great detail, here is a brief synopsis of each tier.

A. Tier # 1[2]

Generally this is oil produced from property on which oil was originally discovered and put into production before January 1, 1979. This class will include any other oil not fitting into tier # 2 or tier # 3. It receives the highest tax rate of all classes.

B. Tier # 2[3]

This is stripper oil and oil in which the U.S. has an economic interest — i.e., National Petroleum Reserve Oil. Stripper oil encompasses property whose average daily production of crude did not exceed 10 barrels per day during any preceding consecutive 12-month period beginning after December 31, 1972.

C. Tier # 3[4]

This includes oil which is newly discovered, heavy oil, and incremental tertiary oil. It does not include Tier # 2 oil.

1) *Newly Discovered Oil* - This is oil produced from property from which there was no commercial production in the calendar year 1978. Production is not commercial if it was produced incidental to exploratory or test wells.

2) *Heavy Oil* - This is oil with an API specific gravity of 16 degrees or less, corrected to 60 degrees Fahrenheit.

3) *Incremental Tertiary Oil* - Basically this is the amount of extra oil attributable to a qualified tertiary recovery operation initiated after May 31, 1979.

Several problems become evident upon a cursory examination of the tiers. For instance, what happens when one class of oil fits into more than one tier? Take for example a royalty owner having production on his or her property since 1975. The production averages less than 10 barrels a day. Is the production tier # 1 (old oil) or tier # 2 (stripper oil)? According to the Internal Revenue Code (IRC), the production would be tier # 2. Tier # 1, by definition excludes oil fitting into any of the other categories.

The formula for determining the magnitude of the WPT is fairly simple.[5] By solving the following equation the royalty owner can determine the imposition of the tax on a per barrel basis.

$$WPT = RTR \times [SP - (ABP + STA)]$$

where:

- WPT = the windfall profit tax calculated on a per barrel basis,
- RTR = the relevant tax rate for each tier of oil involved,
- SP = current market sales price,
- ABP = the adjusted base price as specified in the tax regulations, and
- STA = the state severance tax adjustment.

Before the royalty owner can fully understand and apply the formula, certain amplifications and explanations are necessary. For example, the relevant tax rates (RTR) and the adjusted base prices (ABP) must be known. Both are contained in *Table 2.*

The relevant tax rates (RTR) are fixed by law.[6] They have remained unchanged until the recent passage of the Economic Recovery Tax Act (ERTA) of 1981. (These changes will be discussed later) However, the adjusted base prices (ABP) are not static but are subject to changes each quarter of the year.[7]

Also the royalty owner needs to know what constitutes the current market sales price (SP). According to IRC Section 4988 (C) the sales price (or removal price, as it is called) is the amount for which the barrel is sold. However, if the sale is between related persons, if the oil is removed from the premises before it is sold, or if the oil is refined on the premises, the removal price is the "constructive sales price." The constructive sales price is the price used in determining the gross income from the property for purposes of computing percentage depletion according to Section 613 of the IRC.

And lastly, the royalty owner must understand the state severance tax adjustment (STA).

In general, a state severance tax is levied by a state upon a percentage of the "gross value" of the crude oil removed. If the tax is levied upon anything else such as the value of the remaining reserves, the net proceeds from production or upon a fixed fee

(continued on next page)

Table 1. Windfall Profit Tax Rates[1]

Type of oil	Indep. Co.	Integrated Co.	Royalty Owner
Tier # 1 - Mainly old oil	50%	70%	70%
Tier # 2 - Stipper	30%	60%	60%
Tier # 3 - Newly discoverd Heavy and Incremental Tertiary	30%	30%	30%

Table 2. RTR & ABP for Royalty Owners

Tier	RTR	ABP
#1	70%	$12.81/barrel
#2	60%	$15.20/barrel
#3	30%	$16.55/barrel

per barrel, it is *not* considered a severance tax for purposes of the WPT.[8]

The state severance tax adjustment (STA) as used in the formula refers only to that part of the severance tax levied upon the difference between the adjusted base price (ABP), as discussed earlier, and the decontrolled price of the crude. In order to discourage states from raising the severance tax too high, any rates in excess of fifteen percent (15%) are disregarded in computing the WPT.[9]

The following examples illustrate the impact of the WPT on royalty owners. For the sake of simplicity, the quarterly adjustments to the ABP have been ignored due to its constant change. Also the STA has been dropped from the formula because of its variance among the states.

A. Example of Tier #1 Oil

Consider a royalty owner who has a well that has consistently produced 100 barrels a day for the past five years. The royalty owner has a 1/8 royalty interest in the well or a fully vested interest in 12.5 barrels of daily production (1/8 of 100).

The oil is being sold at the market price of $32.00 per barrel. Net expenses deducted to the royalty owner are $4.00 per barrel. The royalty owner would receive approximately $10,500 a month if there was no WPT. ($28/barrel × 12.5 barrels/day × 30 days).

Under these circumstances, the royalty owner would suffer a $13.43 tax per barrel from the imposition of the WPT.

WPT = Relevant Tax Rate × (Selling Price - Adjusted Base Price)
or
$13.43 tax/barrel = .70 × ($32.00 - $12.81)

The royalty owner's monthly check would actually approximate $5463.75.

$5463.75 = ($28 net per barrel to owner - $13.43 tax/barrel) × 12.5 barrels/day × 30 days.

B. Example of Tier #2 Oil

Again assume the same facts except the royalty owner has a 1/8 interest in 12 stripper wells on different property and each well has consistently produced eight barrels a day for the past five years. Assuming the same selling prices and expenses mentioned earlier are applicable to this royalty owner, the monthly check would be approximately $10,080 if there was no WPT.

[$28/barrel × (1/8 of 96 barrels/day) × 30 days]

The royalty owner would suffer a $10.08 tax per barrel from the WPT.

$10.08 tax/barrel = .60 × ($32.00 − $15.20)

The royalty owner's check would actually approximate $6451.20.

$6451.20 = ($28 net per barrel to owner − $10.08 tax/barrel) × 12 barrels/day × 30 days.

C. Example of Tier #3 Oil

Last of all, assume the same set of facts except the 100 barrels per day is flowing from an oil field discovered in February 1979.

In this case, the royalty owner's check would be the same as in case #1 — i.e. $10,500. if there was no WPT.

($28/barrel × 12.5 barrels/day × 30 days)

The royalty owner would suffer a $4.64 tax per barrel from the WPT.

$4.64 tax/barrel = .30 × ($32.00 − 16.55)

The royalty owner's check would actually approximate $8760 after the tax.

$8760 = ($28 net per barrel to owner − $4.64 tax/barrel) × 12.5 barrels/day × 30 days

As one can readily see, tier #1 would suffer the most. Also note that if the current selling price of crude were the same as the specified adjusted base price levels, the royalty owner would experience no change in the monthly payments. This fact can be easily demonstrated by using the figures in case #1. If the oil was selling for $12.81/barrel immediately before and after the tax was imposed, there would be no WPT.

Tax/barrel = .70 × ($12.81 − $12.81)
Tax/barrel = 0

It is far more important for the royalty owner to grasp how the tax is computed than to be able to actually figure it. According to IRC Section 4995, the WPT is both withheld and paid by the first purchaser of the oil. Consequently the actual computation and payment of the tax is beyond the control of royalty owners who are not oil purchasers.

D. Recent Developments in the WPT

The Economic Recovery Tax Act of 1981 increased the royalty owner's credit from $1,000 to $2,500 for the year 1981.[10] It eliminated all subsequent annual credits and replaced them with a two-barrel a day qualified exemption or refund from production for the years 1982, 1983, and 1984. For the year 1985 and thereafter, the daily exemption goes to three barrels a day. Certain limitations on the exemptions are specified for related taxpayers and family farm corporations![11]

Royalty owners whose share of daily production does not exceed 2 barrels a day on a quarterly basis may exempt themselves from the amount of this withholding by filing Form 6783 with the purchaser of the oil or other withholding agent.

If the form is not filed, the purchaser or other withholding agent will be required to withhold taxes on all the production. In such cases, the royalty owner must file Form 6249 with his or her annual tax return in order to obtain the taxes on the withheld exempted production.

Second, the new law lowers the WPT rate on tier #3 — i.e., newly discovered oil. The reduction will go from the present 30% to 15% over a five-year period according to *Table 3!*[12]

The new rates have been instituted to stimulate exploration and development of new oil prospects.

Lastly, stripper oil produced by independent producers will be completely exempt from the WPT beginning in 1983. This provision does not appear to give the same relief to royalty owners who have an interest in the same stripper well(s)![13]

E. The WPT and Depletion Allowances

A problem voiced by many royalty owners was the treatment of the WPT on the individual's tax return. Section 164(a)(5) of the Code allows a deduction for the amount of the WPT paid or withheld during the tax year. Royalty owners also eligible for percentage depletion did not know whether the deduction was allowed before or after the percentage depletion was calculated. Here is the question.

Percentage depletion is computed by taking a stipulated percent of the "gross income from the property." The royalty owner were wondering if the "gross income from the property" was first adjusted downward to reflect the amount of the WPT paid or withheld before the percentage depletion was figured. According to the Regulations, the percentage depletion is taken *before*, not after, the WPT is deducted.[14]

Cost depletion appears to be calculated in much the same manner.

Conclusion

Even though royalty owners do not calculate and pay the WPT directly, some basic knowledge of the tax is important. Qualified royalty owners should make sure the Form 6783 is filed with the purchaser or entity withholding the tax so that a quicker return for the daily exemption can be achieved. Also, the proper deduction of the tax on the individual's tax return in relation to the depletion allowances can save time and money.

1. I.R.C. Sec. 4987
2. I.R.C. Sec. 4991(c)
3. I.R.C. Sec. 4991(d)
4. I.R.C. Sec. 4991(e)
5. I.R.C. Sec. 4987 and Sec. 4988
6. I.R.C. Sec. 4987(b)
7. I.R.C. Sec. 4989(c) and (d)
8. I.R.C. Sec. 4996(c)
9. Ibid
10. I.R.C. Sec. 6429(a) through (d), as amended by the Economic Recovery Tax Act of 1981
11. I.R.C. Sec. 4994(f), as amended by the Economic Recovery Tax Act of 1981
12. I.R.C. Sec. 4987(b)(3), as amended by the Economic Recovery Tax Act of 1981
13. I.R.C. Sec. 4991(b), as amended by the Economic Recovery Tax Act of 1981
14. I.R.C. Section 164(a)(5)

Table 3. New WPT Rates on Newly Discovered Oil

1981	1982	1983	1984	1985	1986
30%	27½%	25%	22%	20%	15%

continued from page 2

Status as Section 1245 property

The Economic Recovery Tax Act of 1981 made it clear that single purpose agricultural (and horticultural) structures are Section 1245 property. The final regulations, however, permit facilities placed in service before 1981 to be treated as Section 1250 property for depreciation recapture purposes *if rapid depreciation methods were not used that could only be used for Section 1245 property*.

Dairy facilities

A pair of recently published letter rulings have focused on eligibility of dairy facilities as "single purpose agricultural structures." In *Ltr. Rul. 8323011, March 2, 1983*, a structure was eligible that was built for a dairy operation. The structure was composed of

> "...(A) bottom base section containing stalls for the dairy cows and a loft, located in the roof section of the structure. The loft runs the length of the roof peak of the structure and is used for the storage of hay used to feed all the dairy cattle in the structure....
>
> "The base section also houses equipment, used in the housing, raising and feeding of dairy cows and their produce, such as 44 stalls for the dairy cows, 17 stalls for the yearlings, a box stall for fresbing the dairy cows, and a sloping pipeline which runs through the structure following the stalls, for carrying the milk to the bulk milk tank."

The hay storage was less than 11% of the total volume of the structure.

In *Ltr. Rul. 8324009*, no date given, a similar facility was eligible for investment tax credit. In that facility, hay storage made up about 29% of total volume of the structure.

— *Neil E. Harl*

Watch contingent remainders

It is clear that the creation of contingent remainder interests at the death of a landowner can cause serious problems of eligibility for special use valuation of land. In *Ltr. Rul. 8346006, July 29, 1983*, the question was raised whether the remote possibility that the property might pass to individuals outside the decedent's family would bar special use valuation.

> Example: X dies leaving land to the surviving spouse, Y, for life, remainder interest to the four children. The will provides that if any child predeceases Y, that child's interest is to pass to the other children or their issue. If no children or issue survive Y, the property is to pass to X's heirs as though X had died intestate under the laws of that state.

The low probability that all X's issue would predecease Y with the result that X's land would pass to X's heirs in intestacy is apparently sufficient to preclude special use valuation for the land.

For that reason, it is essential *that all wills and trusts (of individuals holding land for which special use valuation may be desired) be reviewed and, where necessary, revised to assure that — (1) all interests including remainder interests vest in family members of the landowner at the landowner's death or (2) provisions be added limiting, in all events, passage of property interests only to members of the landowner's family.*

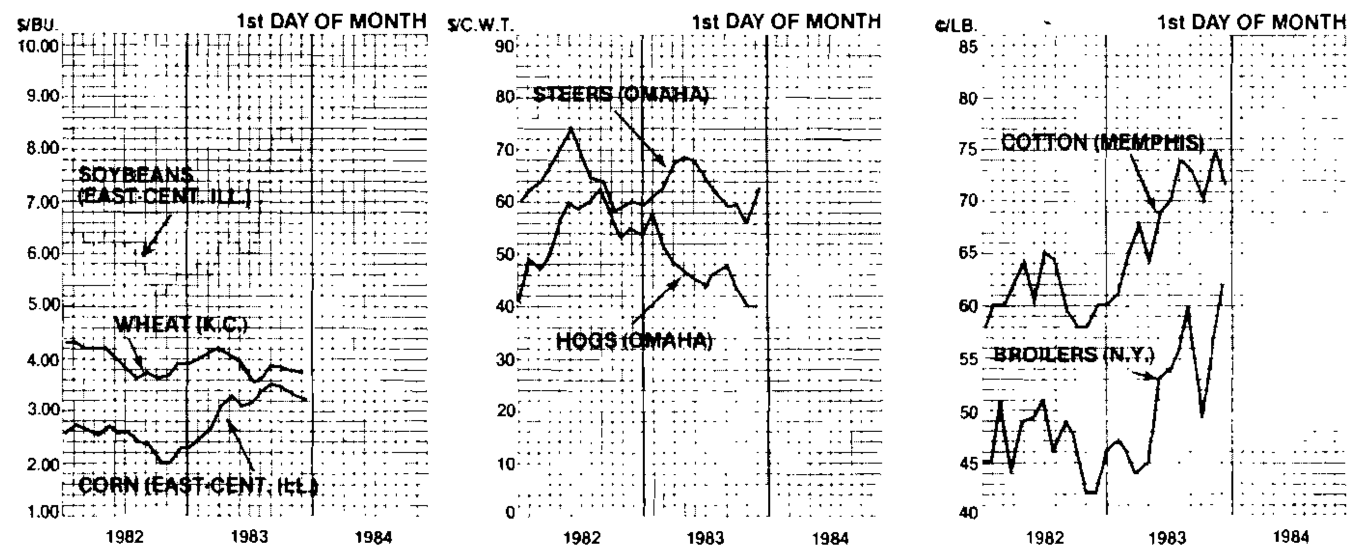
In an earlier ruling, *Ltr. Rul. 8332012, April 22, 1983*, a contingent devise to a charitable organization on failure of a spouse or issue to survive barred special use valuation.

The so-called disaster or catastrophic clauses providing for disposition of property if no member of the immediate family survives *should only be used with utmost caution*. The decedent's dispositive instrument must not be the means by which, even on a low probability basis, the decedent's land can pass outside the decedent's family if special use valuation is to be assured.

The need for careful drafting is also dramatized by recently published *Ltr. Rul. 8349008, August 23, 1983*. In that ruling, the husband as the surviving spouse received a life estate in farmland with the farmland passing under a testamentary special power of appointment in the husband. In the event the power of appointment was not exercised, the property was to pass to the decedent's children then surviving and the children of any predeceased child. If a deceased child did not have living descendants, the property was to pass to the decedent's living descendants. If there were no descendants of the decedent, a "catastrophic" clause would be activated with the property divided into two parts with one part "distributed to the heirs of my husband per stirpes, and one part to my heirs per stirpes to be determined as though we had died at the termination of the life estate." Special use valuation was barred because — (1) the special power of appointment was not limited to qualified heirs and (2) the property could have passed outside the decedent's family under the catastrophic provision.

— *Neil E. Harl*

TRENDS



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