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DEPRECIATING PROPERTY ACQUIRED FROM RELATED PARTIES

— by Neil E. Harl*

Traditionally, a substantial amount of farm property is transferred within the family.¹ A major issue is how depreciation is claimed on the items following the transfer.²

Expense method depreciation

Property acquired from a related party is not eligible for expense method depreciation.³ For this purpose “related party” includes a spouse, ancestors, lineal descendants and controlled entities.⁴

Regular depreciation

For purposes of regular depreciation under MACRS (Modified Accelerated Cost Recovery System) the question is whether the “anti-churning” rules apply.⁵ Those provisions, originally added in 1981, identified six classes of property that were not eligible for the more rapid depreciation allowances under ACRS (Accelerated Cost Recovery System).⁶ Those rules were extended by the Tax Reform Act of 1986 to include property placed in service after 1986 under MACRS (or on an item by item basis after July 31, 1986) with two exceptions — (1) the anti-churning rules were not extended to residential rental property or nonresidential real property;⁷ and (2) the anti-churning rules do not apply to property where, for the first full taxable year after being placed in service, the depreciation deductions under rules in effect before the Tax Reform Act of 1986 was enacted would be greater than the amount allowable under the 1986 legislation using the half-year convention.⁸ In general, that condition is met inasmuch as MACRS depreciation under the Tax Reform Act of 1986 provided for less rapid depreciation than under the ACRS system applicable before 1987.⁹ If either condition is met, the same depreciation rules apply to property acquired from a related party as from an unrelated transferor. Thus, for “property used in a farming business,”¹⁰ which is defined as used in the “trade or business of farming,”¹¹ the maximum depreciation is 150 percent declining balance for 3, 5, 7 and 10 year property.¹² The same 150 percent declining balance rate is the maximum allowable for 15 and 20-year property.¹³

If the two conditions in the Tax Reform Act of 1986¹⁴ are not met, the anti-churning rules apply.

Anti-churning rules

Of the five anti-churning rules applicable to Section 1245 property,¹⁵ the one most likely to cause problems in related party transactions is the “related party” rule.¹⁶ Under that provision, the term “recovery property” does not include Section 1245 class property if the property was owned or used at any time during 1980 (or 1986) by the taxpayer or a related party.¹⁷ The term “related party” for this purpose includes brothers or sisters, whether of the whole or half blood; spouse; lineal ancestors and lineal descendants.¹⁸ Apparently, in that event the depreciation is calculated using pre-1981 rules for property not classified as “recovery property.”¹⁹ The related party anti-churning rule does not apply if the property is acquired from the estate of a related party where the property received a new income tax basis at death.²⁰ Thus, property acquired from the estate of a closely-related person is eligible for cost recovery even though acquisition of the property during life from the same individual would have barred cost recovery under ACRS (or MACRS) if the property had been owned or used by the related person in 1980 (or 1986).²¹ The term “related party” does not include a divorced spouse²² but the term does include those engaged in trades or businesses under common control.²³

The anti-churning rules also apply to property placed in service before 1981 (or before 1987) which was acquired by the taxpayer after 1980 (or 1986) in various types of tax-free exchanges.²⁴

The third anti-churning rule covers property acquired from a person who owned the property at some time during 1980 (or 1986) and, as part of the transaction, the user of the property did not change.²⁵

The fourth anti-churning rule applies to property leased to a person (or a person related to that person) who owned or used the property at any time during 1980 (or 1986).²⁶

Finally, the anti-churning rules reach property acquired in a transaction as part of which the user does not change and the property is not “recovery property” in the hands of the person from whom it was acquired by reason of the third or fourth anti-churning rules.²⁷

Two additional anti-churning rules are applicable to Section 1250 property acquired after 1980 if — (1) the property comes under the first, second or fourth anti-churning rules for Section 1245 property, or (2) the property was acquired in a tax-free exchange, involuntary conversion

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reinvestment, reacquisition for indebtedness or low income housing reinvestment to the extent the basis represents the basis of other property owned by the taxpayer or a related person during 1980 (or 1986).²⁸ The latter rule could apply to tax-free exchanges involving farm buildings (20-year property).²⁹

FOOTNOTES

- ¹ See generally 6 Harl, *Agricultural Law* ch. 47 (1996); Harl, *Agricultural Law Manual* § 6.02 (1996). See Harl, "More on Related Party Sales," 5 *Agric. L. Dig.* 185 (1994).
- ² See 4 Harl, *supra* n. 1, ch. 29; Harl, *supra* n. 1, § 4.03[4].
- ³ I.R.C. § 179(d)(2)(A), (B).
- ⁴ See I.R.C. § 179(d)(2)(A).
- ⁵ I.R.C. § 168(f)(5)(A); I.R.C. § 168(e)(4), before amendment by Tax Reform Act of 1986, Pub. L. 99-514, Secs. 201-204.
- ⁶ I.R.C. § 168(e)(4)(A), before amendment by Tax Reform Act of 1986.
- ⁷ I.R.C. § 168(f)(5)(B)(i).
- ⁸ I.R.C. § 168(f)(5)(B)(ii).
- ⁹ For a comparison of the two depreciation systems, see 4 Harl, *supra* n. 1, §§ 29.05[2][c], 29.05[2][d].
- ¹⁰ I.R.C. §§ 168(b)(2)(B), 263A(e)(4).
- ¹¹ I.R.C. § 263A(e)(4)(A). The definition also includes operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts or other crops; and ornamental trees (other than evergreen trees more than six years old when severed from the roots). I.R.C. § 263A(e)(4)(B).
- ¹² I.R.C. § 168(b)(2)(B).
- ¹³ I.R.C. § 168(b)(2)(A).

¹⁴ See ns. 7 and 8 *supra*.

¹⁵ See n. 5 *supra*.

¹⁶ I.R.C. § 168(e)(4)(A)(i), before amendment by Tax Reform Act of 1986.

¹⁷ *Id.*

¹⁸ I.R.C. §§ 168(e)(4)(D)(i), before amendment by Tax Reform Act of 1986, 267(c)(4).

¹⁹ I.R.C. § 168(e)(4)(A)(i), before amendment by Tax Reform Act of 1986.

²⁰ I.R.C. § 168(e)(4)(H), before amendment by Tax Reform Act of 1986.

²¹ Prop. Treas. Reg. § 1.168-4(d)(9).

²² See *Drake v. United States*, 642 F. Supp. 830 (N.D. Ill. 1986) (taxpayer's interest in condominium purchased from divorced spouse in 1981 eligible as recovery property where spouse's interest in condominium held with taxpayer during marriage as tenants by entirety).

²³ I.R.C. §§ 168(e)(4)(d)(ii), before amendment by Tax Reform Act of 1986, 52(a), (b).

²⁴ See I.R.C. § 168(e)(4)(C), before amendment by Tax Reform Act of 1986.

²⁵ I.R.C. § 168(e)(4)(A)(ii), before amendment by Tax Reform Act of 1986.

²⁶ I.R.C. § 168(e)(4)(A)(iii), before amendment by Tax Reform Act of 1986.

²⁷ I.R.C. § 168(e)(4)(A)(iv), before amendment by Tax Reform Act of 1986.

²⁸ I.R.C. § 168(e)(4)(B)(iii), before amendment by Tax Reform Act of 1986.

²⁹ I.R.C. § 168(c)(1).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

FENCE. The plaintiffs had purchased their land in 1967 with a barbed wire fence around it. The land was used to graze cattle and the plaintiff planted trees along one portion of the fence. In 1988, the defendant purchased neighboring land and had the land surveyed. The survey showed the fence to be on the defendant's land and the defendant removed the fence from the defendant's land and replaced it with a wooden fence. The plaintiff claimed ownership of the disputed strip by adverse possession based upon the existence of the fence. The plaintiff provided evidence that the land had been continuously used for grazing cattle; however, the court held that the fence was only a casual fence, insufficient to show adverse possession, because the plaintiffs failed to provide evidence of the original purpose of the fence when it was constructed. The court also held that mere pasturing of cattle was insufficient use to constitute adverse possession. The court denied the plaintiffs' claim that the fence was the boundary by acquiescence, because the plaintiffs failed to show that the fence was considered the boundary line by previous owners as a result of a boundary dispute. **Mohnke v. Greenwood**, 915 S.W.2d 585 (Tex. Ct. App. 1996).

The parties owned neighboring tracts of farm land separated by a fence which had been in existence at its current location since the 1880s. The court found that the pre-1977 owners of the tracts had acquiesced to the fence as the boundary between the tracts; however, in 1977 both tracts were owned by one company for 15 days. In the history of the tracts, all the conveyances and deeds described the boundary truthfully without mentioning the fence which was about 100 feet on to the defendant's property. The court held that the common ownership of both tracts destroyed the acquiescence of the fence as the boundary and started the time limits for adverse possession anew; therefore, the plaintiff did not acquire title to the disputed land by adverse possession. **Salazar v. Terry**, 911 P.2d 1086 (Colo. 1996), *aff'g*, 892 P.2d 391 (Colo. Ct. App. 1994).

ANIMALS

ANIMAL NUISANCE. The defendant was convicted twice of violating Revised Ordinance of Honolulu §§ 7-2.2(a), 7-2.3 for keeping roosters which were noisy in the early morning. In both cases the convictions arose from a complaint of a neighbor and a single citation from an investigating officer. The defendant argued that both