Agricultural Law Digest

An Agricultural Law Press Publication | Volume 5, No. 7 | April 1, 1994
Editor: Robert P. Achenbach, Jr. | Contributing Editor Dr. Neil E. Harl, Esq. | ISSN 1051-2780

DETERMINING THE RESIDENCE PART OF A FARM OR RANCH

— by Neil E. Harl*

On sale of a farm or ranch, it can be important how much of the transaction is attributable to the residence and how much to the rest of the farm.[1] The question can be significant for purposes of sale and possible tax free reinvestment of the residence portion of the transaction,[2] sale of the residence after age 55,[3] and disallowance of any loss on the residence part of the transaction.[4]

If the residence is sold as a part of the entire farm or ranch, it may also be necessary to apportion the remaining basis between the residence and the soil, neither of which is depreciable, if that allocation has not already been accomplished. The apportionment of basis may have been severely restricted by virtue of earlier allocations of basis among depreciable items of property.

Sale and reinvestment of residence

The term "residence," for purposes of the sale and tax-free reinvestment provision,[5] is defined broadly by regulations and provides relatively little guidance as to how much of a farm or ranch would be eligible for postponement of gain.[6] The residence may not, however, include any part of the premises used for business purposes.[7] Thus, the term "residence" apparently would not include a garage housing a business vehicle on a regular basis and would not include the portion of the residence "exclusively used on a regular basis" as an office in the home.[8] With scalpel-like precision, the office portion of the residence must be carved out and not treated as part of the sale of the principal residence. However, the business portion of the residence is eligible for sale and reinvestment *if no income tax deduction was allowed for the business use in the year of sale*.[9]

In a 1964 Tax Court case,[10] a residence of five acres (out of 236.6 acres) qualified for sale and reinvestment treatment. Under a 1979 Tax Court decision, a residence of 1.5 acres out of seven acres was eligible for the rollover provision.[11] An earlier U.S. District Court case[12] approved a country estate of 65 acres for sale and reinvestment treatment.

Sale after age 55

For purposes of the exclusion (for up to $125,000 of gain) on the principal residence for taxpayers age 55 or older,[13] the term "residence" has the same meaning as for the sale and reinvestment[14] of the proceeds from the sale of the residence.[15] Indeed, the same problems arise with the over 55 sale (ascertaining the portion of the transaction which is "residence," determining the basis properly allocable to the residence and calculating the portion of the sales price attributable to the residence) as for the sale and reinvestment provision.

Losses on the residence

As noted,[16] losses on the personal residence are personal losses and, therefore, are not income tax deductible.[17] Thus, if a farm is sold for a single price under circumstances such that a loss may have been sustained on the residence portion, the Internal Revenue Service may require that the transaction be treated as separate sales of the residence and the rest of the farm with the loss on the residence portion nondeductible.[18] A contract provision as to the value and extent of the residence may be persuasive evidence of value of the residence. A loss on the residence can very well occur, considering improvements that may have been made to the residence over the years, the fact that a residence occupied by the owner is not depreciable and the fact that many rural communities have a surplus of housing because of farm consolidation.

Loss on sale of the residence by the surviving spouse may be deductible if it can be demonstrated that the loss was incurred in a "transaction entered into for profit."[19] Moreover, a loss on the residence may be deductible if the residence had been rented prior to sale[20] although rental incident to sale of the property is immaterial.[21] For purposes of determining loss, the basis for property converted from personal to business use is the lesser of the adjusted basis at the time of the conversion or fair market value of the property at the time of the conversion adjusted for improvements and depreciation for the period between conversion and sale.[22]

FOOTNOTES

1 See generally 5 Harl, *Agricultural Law* § 48.02[1] (1993); Harl, *Agricultural Law Manual* § 6.03[2] (1993).
2 See I.R.C. § 1034.
3 I.R.C. § 121.
4 Treas. Reg. § 1.165-9(a). See Cottrell v. Comm'r, T.C. Memo. 1970-218.
5 I.R.C. § 1034.
6 See Treas. Reg. § 1.1034-1(c)(3)(ii).

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

Agricultural Law Digest is published by the Agricultural Law Press, P.O. Box 5444, Madison, WI 53705, bimonthly except June and December. Annual subscription $100. Printed on recycled paper by Accurate Business Service, Madison, WI.

[7] *Id*.
[8] I.R.C. § 280A(c)(1).
[9] Rev. Rul. 82-26, 1982-1 C.B. 114.
[10] Est. of Campbell v. Comm'r, T.C. Memo. 1964-83.
[11] Lokan v. Comm'r, T.C. Memo. 1979-380.
[12] Bennett v. U.S., 61-2 U.S.T.C. ¶ 9697 (N.D. Ga. 1961).
[13] I.R.C. § 121.
[14] I.R.C. § 1034.
[15] Treas. Reg. § 1.121-3(a).
[16] See n. 4 *supra*.
[17] Treas. Reg. § 1.165-9(a).
[18] See O'Byrne and Davenport, Farm Income Tax Manual § 329(c) (9th ed. 1987).
[19] See Est. of Miller v. Comm'r, T.C. Memo. 1967-44 (vacation residence).
[20] See Treas. Reg. § 1.165-9(b)(1).
[21] Dawson v. Comm'r, T.C. Memo. 1972-4; Henry v. Comm'r, T.C. Memo. 1983-277.
[22] Treas. Reg. § 1.165-9(b)(2).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

DISCHARGE. The debtor was the president and a director of a grain dealer corporation that was also in bankruptcy. The trustee in the corporation's case sought an order denying the discharge of the debtor under Section 727(a)(3) for falsification of records to the state department of agriculture and the corporation's auditors. The debtor argued that Section 727(a)(3) applied only where the falsification prevented the trustee from obtaining accurate financial records and did not apply to falsification as to third parties. The court held that because the debtor's actions did not prevent the trustee from obtaining accurate records in the bankruptcy case, the discharge would not be denied. The court noted that the corporation's own poor records prevented the trustee from obtaining accurate information. The trustee also sought to deny the debtor's discharge under Section 523(a)(2) for tendering false financial records to the state department of agriculture, resulting in continuation of the corporation's grain dealer license, credit purchases from some producers, and the corporation's failure to pay for these purchases. The court held that the trustee could not bring a dischargeability action on behalf of only some of the corporation's creditors. The trustee in the corporation's case also sought denial of discharge of the debtor for fraud while in a position of fiduciary duty. The court held that a director of a corporation does not serve as a fiduciary as to the corporation's creditors. ***In re* Martin, 162 B.R. 710 (Bankr. C.D. Ill. 1993)**.

ESTATE PROPERTY. Two years before filing for bankruptcy, the debtors had established a revocable trust with the debtors as trustees and beneficiaries. The debtors had the right to revoke the trust at any time. The court held that the right to revoke the trust was a property interest which passed to the bankruptcy estate and the trustee had the power to revoke the trust. ***In re* Ross, 162 B.R. 863 (Bankr. D. Idaho 1993)**.

EXEMPTIONS.

AVOIDABLE LIENS. After subtraction of the consensual liens against the debtor's homestead, the debtor had equity in excess of the exemption amount. The debtor argued that the fair market value of the house should be reduced by the hypothetical costs of sale, but the court rejected that valuation because the house was not going to be sold. The debtor sought to avoid a judgment lien against the house which partially impaired the exemption, arguing that the entire lien should be avoided so that the debtor would receive any future appreciation. The court held that the judgment lien would be avoided only to the extent the lien impaired the exemption. ***In re* Abrahimzadeh, 162 B.R. 676 (Bankr. D. N.J. 1994)**.

HOUSEHOLD GOODS. The debtor claimed an exemption, under Va. Code § 34-29, for two televisions, a record player and a VCR. The court held that the items were household goods eligible for the exemption. ***In re* Hanes, 162 B.R. 733 (Bankr. E.D. Va. 1994)**.

OBJECTIONS. The debtor originally filed a Chapter 13 case and claimed $3,000 in property as exempt. No objections to the exemptions were filed. The case was converted to Chapter 7 and another creditors' examination took place and the trustee filed an objection to the exemptions within 30 days after the examination. The debtor argued that the objection was invalid as untimely because it was not filed within 30 days after the Chapter 13 creditors' examination. Although the court recognized that the rules did not explicitly provide for a new time limit for objections after a conversion, the court held that the conversion restarted the time limit for objections to exemptions and that the trustee's objection was timely. ***In re* Jenkins, 162 B.R. 589 (Bankr. M.D. Fla. 1993)**.

RETIREMENT PLANS. The debtor owned an interest in two retirement plans established by two companies for their retired directors. The plans were paid from the companies' general revenues on an annual basis and did not create any fund or trust corpus. The plans were not ERISA qualified. The plans had spendthrift clauses restricting the debtor's transfer rights as to future payments. The court held that the plans did not create trusts excludible from the bankruptcy estate. ***In re* Hanes, 162 B.R. 733 (Bankr. E.D. Va. 1994)**.

CHAPTER 12-*ALM* § 13.03[8].*

ATTORNEY-CLIENT PRIVILEGE. The FmHA sought conversion of the debtor's Chapter 12 case to Chapter 7 for fraud in attempting to hide assets belonging to the bankruptcy estate. During the Rule 2004 examination of the debtor, the FmHA discovered that the debtor had not disclosed in the bankruptcy schedules bank account funds