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Publisher/Editor

Robert P. Achenbach, Jr.

Contributing Editor

Dr. Neil E. Harl, Esq.

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Machinery Trades: Also a Like-Kind Exchange

-by Neil E. Harl*

Few tax events occur more frequently in farming and ranching than machinery trades. What is not always recognized is that such trades are almost always categorized as like-kind exchanges and should be treated and reported as such.¹ Moreover, the Department of the Treasury (and the Internal Revenue Service) have implemented more restrictive rules governing personal property like-kind exchanges than real estate exchanges although the latter, by their size, are usually given more attention. A recently litigated case, *North Central Rental and Leasing v. United States*² has focused attention on the more questionable side of like-kind exchanges involving personal property including equipment used in a business where reliance is placed on qualified intermediaries to avoid the related party rule.

Reporting exchanges

Like-kind exchanges of all types are to be reported to the Internal Revenue Service whether or not there is any gain or loss recognized in the exchange. Taxpayers are required to file Form 8824, *Like-Kind Exchanges*, with either Schedule D or Form 4797, *Sales of Business Property*. The form is to be filed in the year in which the property given up was transferred. For exchanges between related parties, the form must be filed for the two years following the year of the exchange.³

Trading owned for leased property

Trading in an owned item for a leased replacement, although widespread, apparently is not a like-kind exchange.⁴ In another setting, a lessee's sale and leaseback of improved rental property has been held to trigger ordinary income.⁵

Recapture of depreciation

One potential area for an IRS challenge is where recapture of depreciation was ignored under Section 1245 (for depreciable personal property and "other property")⁶ as well as Section 1250 property.⁷ Under Section 1245, embracing most items of machinery and equipment, Section 1245 recapture basically must be recognized as to part or all of the gain.⁸ Thus, recapture income is recognized to the extent of the fair market value of property acquired in a like-kind exchange that is not depreciable personal property in such a situation, even if no gain is recognized under the like-kind exchange rules.⁹ The recaptured gain is reportable "up front" in the exchange, unlike the rules for Section 1250 property for which gain is partially or totally deferred until there is a disposition of the acquired property.¹⁰

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

North Central Rental & Leasing v. United States

In a recently decided case in the Eighth Circuit Court of Appeals, *North Central Rental & Leasing*,¹¹ a corporation's sales of equipment using a qualified intermediary (a QI was used because of the related party rules) did not qualify as like-kind exchanges where the deals were designed as like-kind exchanges but to allow the corporation to defer gain on the disposition of the low basis equipment which allowed a related entity to pay tax on the "sale" of higher basis replacement items. As set up, immediately after the deal was closed, a third party owned the low basis property, the corporation was holding the replacement property and the related entity was holding the sale proceeds. The transactions were held not to be entitled to non-recognition treatment inasmuch as they were structured to avoid the restrictions in the statute (and regulations) under the related party rules¹² and violated the two-year rule for related party transactions.¹³ The qualified intermediary was ineffective in avoiding the related party rules.

A recent case, appealed to the Supreme Court had earlier established that a qualified intermediary affords no protection against a charge that the transaction is a related party transaction¹⁴ followed by *Ocmulgee Fields, Inc. v. Commissioner*¹⁵ with basically the same outcome. With related party transactions, transfers by either party within two years of a like-kind exchange of property with a related person triggers the recognition of gain.¹⁶

A partition of property

All of this does not endanger ordinary partitions of property (which have become relatively common in settling estates) so long as the partition does not involve the exchange of property interests that differ materially either in kind or extent.¹⁷ Thus, changing fence lines to adjust for differing qualities of land to give some heirs more or less than their equal share, for example, does not violate the related party rule and does not require the two-year wait for transfers to occur. Giving and receiving "boot" to equalize inherited property values or other non-like kind property between or among family members takes the transfer out of the category of a partition and into the category of related party transactions that trigger the so-called "two-year" rule.¹⁸

ENDNOTES

¹ See generally 1 Harl, *Farm Income Tax Manual* § 2.07 (2015 ed.); 4 Harl, *Agricultural Law* § 27.04 (2014); Harl, *Agricultural Law Manual* § 4.02[16] (2014).

² 2015-1 U.S. Tax Cas. (CCH) ¶ 50,217 (8th Cir. 2015).

³ Instructions to Form 8824, dated June 16, 2014.

⁴ Cf. *Halle, IV v. Comm'r, T.C.* Memo. 1996-116 (loss on personal use portion of item traded in disallowed; lease payments allowed).

⁵ TAM 201027045, March 15, 2010.

⁶ I.R.C. § 1245(b)(4); Treas. Reg. § 1.1245-4(d)(1).

⁷ I.R.C. § 1250(d)(4); Treas. Reg. § 1.1250-3(d).

⁸ I.R.C. § 1245(b)(4); Treas. Reg. § 1.1245-4(d)(1).

⁹ I.R.C. § 1245(b)(4)(B).

¹⁰ I.R.C. § 1250(d)(4)(E).

¹¹ 2015-1 U.S. Tax Cas. (CCH) ¶ 50,217 (8th Cir. 2015).

¹² I.R.C. § 1031(f)(4).

¹³ I.R.C. § 1031(f)(1).

¹⁴ *Teruya Brothers, Ltd. & Subs. v. Comm'r*, 124 T.C. 45 (2005), *aff'd*, 580 F.3d 1038 (9th Cir. 2009), *cert. denied*, 2/22/10 (unsuccessful attempt to avoid related party rules in like-kind exchange; used qualified intermediary).

¹⁵ 132 T.C. 105 (2009), *aff'd*, 613 F.3d 1360 (11th Cir. 2010) (same).

¹⁶ I.R.C. § 1031(f)(1). The term "related party" is defined in I.R.C. §§ 267(b) and 707(b)(1). See Harl, "Related Persons: Always Check the Definition – A Lesson From Like-Kind Exchanges," 20 *Agric. L. Dig.* 89 (2009).

¹⁷ Treas. Reg. § 1.1001-1(a).

¹⁸ I.R.C. § 1031(f).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

FEDERAL FARM PROGRAMS

AGRICULTURAL CONSERVATION EASEMENT PROGRAM. The 2014 Farm Bill consolidates the purposes of the Farm and Ranch Lands Protection Program, Grassland Reserve Program, and Wetlands Reserve Program into one easement program called the Agricultural Conservation Easement Program (ACEP). ACEP restores, protects, and enhances wetland on eligible land;

protects the agricultural use, viability, and related conservation values of eligible land by limiting non-agricultural uses of that land; and protects grazing uses and related conservation values by restoring and conserving eligible land. The NRCS and CCC have issued interim regulations which set forth the policies and procedures related to implementation of ACEP as authorized by the 2014 Farm Bill. Since the Conservation Farm Option (CFO) is a repealed program that was never implemented, NRCS is replacing the CFO regulations at 7 CFR part 1468 with the regulations necessary to implement ACEP. **80 Fed. Reg. 11031 (Feb. 27, 2015).**

BIOMASS CROP ASSISTANCE PROGRAM. The FSA has adopted as final regulations amending the Biomass Crop Assistance Program (BCAP) regulations to implement changes required by the