No "basis shifting" in related party like-kind exchange, continued from page 4

The holding in *Ltr. Rul. 200706001*

The Internal Revenue Service concluded that the exchange of the taxpayer's 25 percent interest in Parcel #1 for a 100 percent interest in Parcel #3 was a like-kind exchange. In addition, the subsequent sale by the trust of its interest in Parcel #1 was not a disposition that caused recognition of gain to the taxpayers under I.R.C. § 1031(f) ". . . because the avoidance of Federal income tax was not one of the principal purposes of the exchange or subsequent disposition of Parcel #1."

The ruling cites legislative history for the proposition that ". . . dispositions that do not involve the shifting of basis between properties are not taken into account under § 1031(f)(1)©." The taxpayers represented that the respective per-acre bases for the two tracts (#1 and #3) were equivalent as a result of the step-up in basis which occurred when the father had died.

Therefore, because IRS was convinced that one of the principal purposes of the exchange was not the avoidance of federal income tax, the two-year rule did not apply, and no gain was triggered on sale of Parcel #1.

No "cashing out"

In recent months, concerns have been raised in rulings and in a Tax Court case which denied non-recognition treatment for transactions in which related parties made like-kind exchanges of high basis property for low basis property in anticipation of sale of what had originally been low basis property. Such a transaction is viewed as an exchange which is part of a transaction--or series of transactions—to avoid the related party rule and the non-recognition provisions of I.R.C. Sec. 1031 do not apply.

However, in the latest ruling, the exchange did not involve tracts with significantly different basis figures which satisfied IRS that the transaction did not have ". . . as one of its principal purposes the avoidance of Federal income tax."

No mention of "partnership"

Despite the fact that Parcel #1 was owned in co-ownership (tenancy in common) by the siblings, no mention was made of that in the ruling. In recent years, much has been made of the fact that co-ownership in some instances may be deemed to be a partnership. In 2002, IRS issued Rev. Proc. 2002-22 which specified 15 conditions that had to be met for a favorable advance ruling on the proposed exchange where a like-kind exchange involving co-owned property was involved. IRS also removed the provision signaling that rulings would not be issued in that area.

Apparently, IRS was not concerned about that aspect in the latest ruling (which apparently did not involve a request for an advance ruling on that issue) although the ruling was in response to a request for a private letter ruling from the taxpayer. This is consistent with rulings in recent years agreeing that co-ownership situations were not considered to be partnerships.

In conclusion

Although the use of Section 1031 exchanges involving farmland apparently has declined in recent months, the concept continues to be widely used. The latest ruling provides useful guidance in related party exchanges.

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"Adjustable cash rent leases" and division of farm program payments

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In recent months, farm tenants have expressed interest in adjusting existing cash rent leases in an attempt to broker some of the risk associated with rising commodity prices and the stave off the possibility that the landlord will raise the cash rental rate. But, there's a potential problem with fiddling with cash rent leases - how might any adjustment impact the way farm program payments are split between the tenant and the landlord?

Under Farm Service Agency (FSA) rules, if a lease is a cash lease, then the tenant is entitled to the government payments. For share leases, the payments must be split between the landlord and tenant in the same proportion as the crop is shared under the lease. Thus, the question is what effect a so-called flexible cash lease has on the allocation of the government payments between the landlord and the tenant. A flexible cash lease might

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"Adjustable cash rent leases" and division of farm program payments, continued from page 5

technically be a "share" lease and require the government payments to be split between landlord and tenant. Under FSA regulations (7 C.F.R. §1412.504(a)(2)), a lease is a "cash lease" if it "provides for only a guaranteed sum certain cash payment, or a fixed quantity of the crop (for example, cash, pounds, or bushels per acre)." All other types of leases are share leases. The key point is that if the lease is a "cash lease," the tenant gets 100 percent of the farm program payments.

What FSA gets concerned about is whether adjustable cash rent provisions change the character of the lease from "cash" to "share." FSA could take the position that the lease is a share lease even though the lease is labeled a cash lease and the parties (including farm managers) think they have a cash lease. So, the parties may think they have a cash lease with the tenant getting all of the farm program payments. But, if FSA views the arrangement as a share lease, the parties could be booted out of the farm program with payments already made required to be paid back. That's a terrible result.

But, there may be a way to deal with this problem. Because the FSA regulation defines a cash lease as including a lease for a fixed quantity of the crop, tenants can shift some risk of price fluctuations to the landlord and still qualify the lease as a cash lease so that all FSA payments go to the tenant.

Clearly, landlords and tenants must:

(1) make sure that the lease comports with how they intend to divide the farm program payments, and

(2) make sure the lease complies with the farm operating plan that has been filed with FSA.

Updates, continued from page 1

Internet Updates

The following updates have been added to www.extension.iastate.edu/agdm.

Market Strategies – C5-18

Barriers to Entry and Exist – C5-200

Breakeven Sales Volume – C5-201

Breakeven Selling Price – C5-202

Assessing Agricultural Processing Investment Opportunities – C5-230

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