Agricultural Law Press
Publisher/Editor
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Issue Contents

Agricultural Law Digest

Volume 16, No. 24 December 16, 2005 ISSN 1051-2780

"Cashing Out" with Related Party Exchanges

-by Neil E. Harl*

The hazards with related party exchanges under the like-kind exchange rules[1] are well-known. If, within two years of a like-kind exchange of property with a related person, the related person disposes of the property or the taxpayer disposes of the property, the gain is recognized.[2] The like-kind exchange rules recognize three exceptions to the two-year disposition rule – (1) dispositions involving the death of the taxpayer or the related person; (2) dispositions involving a compulsory or involuntary conversion; and (3) where the Internal Revenue Service is satisfied that avoidance of federal income tax is not a principal purpose of the transaction.[3] If a transaction is a related party exchange, the Form 8824 must be filed for the two years following the year of the exchange.

"Cashing out" of the investment

A primary objective in enactment of the related party rules was to deny non-recognition treatment for transactions in which related parties make like-kind exchanges of high basis property for low basis property in anticipation of sale of the low basis property.[4] The related parties have, in effect, "cashed out" of the investment with the result that the original exchange is not accorded non-recognition treatment.[5]

Revenue Ruling 2002-83,[6] issued in late 2002, illustrates the hazards to the tax treatment of the exchange if one of the related parties cashes out in the process. In that ruling, a taxpayer A transferred relinquished property (tract 1) with a fair market value of $150,000 and an income tax basis of $50,000 to a qualified intermediary in exchange for replacement property formerly owned by a related party, B. That property, tract 2, had a fair market value of $150,000 and a basis of $150,000. Individual C, who is unrelated to either A or B wanted to acquire tract 1. C ended up with the first tract, with a fair market value of $150,000. A few days later, B was paid the $150,000 sales price. A ended up with tract 2, C ended up with tract 1 and B "cashed out" of the deal with $150,000 in cash. Had A exchanged with B directly, it would have been a related party exchange and a sale within two years would have triggered gain on the exchanged property.[7] As a consequence, the exchange 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. § 1031 do not apply.[8] Using an unrelated third party to circumvent the related party rule is ineffective in avoiding the strictures of the related party provision. Essentially, the third party involvement is disregarded with the transaction viewed as an exchange by A with B, related parties, with a sale occurring within the two year period specified by the related party rule.[9]

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Next issue will be published on January 6, 2006.
Happy Holidays to You and Yours!

Agricultural Law Digest is published by the Agricultural Law Press, P.O. Box 50703, Eugene, OR 97405 (ph 541-302-1958), bimonthly except June and December. Annual subscription $110 ($90 by e-mail).

A similar fact situation was litigated in *Teruya Bros., Ltd. & Subs. v. Commissioner*[10] which involved an unsuccessful attempt to avoid the related party rules using a qualified intermediary. Again, a sale occurred within two years of the initial exchange and one of the parties "cashed out" within that time period. What occurred was that, in a series of transactions, the taxpayers transferred real properties to a qualified intermediary which sold the properties to unrelated parties. The qualified intermediary used the proceeds and additional funds from the taxpayer to purchase like-kind replacement properties from a related corporation. The taxpayer failed to demonstrate that tax avoidance was not one of the principal purposes of the exchanges.[11] The court concluded that the use of the qualified intermediary was interposed to avoid the related party rule.

In a 2004 private letter ruling,[12] IRS distinguished *Rev. Rul. 2002-83*[13] in holding that there was no "cashing out" of a property interest and no sale was contemplated within the two year period even though one property ended up being acquired by a buyer. As the ruling notes-

> "Upon completion of the series of transactions, both related parties will own property that is like-kind to the property they exchanged. Moreover, neither party will have ever been in receipt of cash or other non-like kind property (other than boot received in the exchange) in return for the relinquished property."

The ruling notes that neither party was in receipt of boot (or any other non-like kind property) in return for the relinquished property other than boot received in the exchange.[14]

This ruling provides one template for planning a transaction to avoid the trap of *Rev. Rul. 2002-83*.[15] The critical feature of the letter ruling is that there was no "cashing out" of their investment by one of the related parties.[16]

In conclusion

It is abundantly clear that "cashing out" by one of the parties in a related party exchange (even with an unrelated qualified intermediary) falls within the related party rules. Unfortunately, that is not unusual with related party exchanges.

Footnotes

[1] I.R.C. § 1031(f). See generally 4 Harl, *Agricultural Law* § 27.04 (2005); Harl, *Agricultural Law Manual* § 4.02[16] (2005). See generally Harl, "Partition and the Related Party Rule," 13 *Agric. L. Dig.* 145 (2002); Harl, "Is a Partition an Exchange?" 14 *Agric. L. Dig.* 41 (2003).

[2] I.R.C. § 1031(f)(1).

[3] I.R.C. § 1031(f)(2).

[4] See H.R. Rep. 247, 101st Cong., 1st Sess. 1340 (1989).

[5] See Ltr. Rul. 9931002, April 12, 1999) (parent-children transaction). See also Ltr. Rul. 200126007, March 22, 2001 (like-kind exchange treatment denied for multi-party exchange involving related parties where there was "basis shifting").

[6] 2002-2 C.B. 927.

[7] I.R.C. § 1031(f)(1).

[8] I.R.C. § 1031(f)(4).

[9] I.R.C. § 1031(f)(1).

[10] 124 T.C. 45 (2005).

[11] See I.R.C. § 1031(f)(2)(C).

[12] Ltr. Rul. 200440002, June 14, 2004.

[13] 2002 C.B. 927.

[14] Ltr. Rul. 200440002, June 14, 2004.

[15] 2002-2 C.B. 927.

[16] Ltr. Rul. 200440002, June 14, 2004. See Ltr. Rul. 9748006, August 25, 1997 (mere interposition of qualified intermediary between parties does not avoid related party rule).

More on Handling CSP Payments

-by Neil E. Harl*

On June 24, 2005, the *Federal Register* (at page 36,557) carried a Notice of Determination by the Secretary of Agriculture that payments under the Conservation Security Program,[1] under criteria specified in the USDA regulations,[2] are ". . . primarily for the purpose of conserving soil and water resources or protecting and restoring the environment."[2] The Secretary is charged with making such a determination in order for the payments to be eligible for the cost share exclusion available under federal income tax law.[3] The Secretary of the Treasury is obligated to make a determination that the payments under the program do not increase ". . . substantially the annual income derived from the property."[4]

The Secretary of Agriculture, in the June 24, 2005 notice, proceeded to state that ". . . this determination permits recipients to exclude from gross income, for Federal income tax purposes, all or part of the *existing practice, new practice, and enhancement activity payments under the extent allowed by the Internal Revenue Service.*"[5] However, as discussed in a November 18, 2005 *Agricultural Law Digest* article,[6] the exclusion provision is limited to "capital improvements."[7] Cost-share payments for the adoption of land-based structural practices should be eligible for the exclusion from income *if the practice is a capital improvement.*"[8] Cost-share payments for the adoption or maintenance of management or vegetative practices would not be excludible from income nor would "existing practice, new practice, and enhancement activity payments"[9] necessarily be excludible from income. Those payments are very likely to be reportable as ordinary income except to the extent the payments are for capital improvements.[10]

The misleading statement in the June 24, 2005 Notice has contributed to the belief by some taxpayers, augmented by statements from Natural Resource Conservation Service offices, that perhaps the entire amount of CSP payments could be excluded from income. That would only be possible if the entire payment amount were to be directed into capital improvements. Considering the nature of the CSP program, that is highly unlikely.

FOOTNOTES

[1] Farm Security and Rural Investment Act of 2002, § 2001, 116 Stat. 134 (2002).

[2] 7 C.F.R. Part 14.

[3] 70 Federal Register 36,557 (June 24, 2005).

[4] I.R.C. § 126(b)(1)(A).

[5] I.R.C. § 126(b)(1)(B).

[6] 70 Federal Register 36,557 (June 24, 2005) (Emphasis added).

[7] Harl, "Reporting Conservation Security Program Payments," 16 *Agric. L. Dig*. 169, 170 (2005).

[8] See Temp. Treas. Reg. § 16A.126-1(a).

[9] *Id.*

[10] 70 Federal Register 36,557 (June 24, 2005).

[11] See note 8 *supra*.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

GENERAL

EXEMPTION

HOMESTEAD. The debtor moved from Iowa to Wisconsin 143 days before filing for Chapter 7 in Iowa. The debtor filed in Iowa because the bankruptcy case involved mostly assets from a retail store in Iowa which was liquidated. The debtor intended to reside permanently in Wisconsin with the debtor's family and had obtained a job and driver's license there. The court held that the Wisconsin homestead exemption law would apply and allowed the homestead exemption for the Wisconsin residence. ***In re* Stone, 329 B.R. 860 (N.D. Iowa 2005)**.

INSURANCE PROCEEDS. The debtor's farming operation included four chicken houses. The houses were collateral for a loan to a bank. The houses were destroyed by a fire and the debtor filed a claim for the loss; however, the insurance company denied the debtor's claim because the debtor refused to provide requested information about the fire. The bank's mortgage agreement contained a standard mortgage clause which provided for coverage for the benefit of the mortgage holder, even if the claim of the insured mortgagee was denied. Under this provision the insurance company paid the bank for the fire losses. The debtor sought to recover these insurance proceeds as estate property in the debtor's Chapter 12 proceeding. The court held that the proceeds were paid separately to the bank under the insurance contract and were not included in the bankruptcy estate. ***In re* Alexander, 329 B.R. 919 (Bankr. M.D. Ga. 2005)**.

FEDERAL TAX

AUTOMATIC STAY. The debtor argued that the IRS violated the automatic stay by sending to the debtor Form CP-158 demanding that the debtor file all delinquent income tax returns. The court held that Section 362(b)(9)(C) specifically exempts a demand for tax returns from the automatic stay. **Pitts v. Comm'r, 2005-2 U.S. Tax Cas. (CCH) ¶ 50,655 (S.D. N.Y. 2005)**.

FEDERAL AGRICULTURAL PROGRAMS

CROP INSURANCE. The FCIC has issued interim regulations allowing for crop insurance in areas where insurance for a particular crop is not offered, usually because the crop is not commonly grown in the area. Under previous law, the FCIC would provide insurance only after receiving data of a history of production of the crop to be insured. Under Section 780 of the Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act of 2006, crop insurance may be offered after receiving data of the crop to be insured or a similar crop. The interim regulations implement this change. **70 Fed. Reg. 71749 (Nov. 30, 2005)**.

The plaintiffs lived together and operated a farm together but were not married, did not have a partnership agreement and did not form a corporation or other entity to operate the farm. Although one plaintiff (the farmer) did most of the farming, the farmer was barred from obtaining crop insurance due to a mistaken listing by the FCIC. The other plaintiff (the insured) applied for crop insurance and believed that the crop insurance policy would cover all of the crop and not just the insured's share of the crop. When the crop was sold, the farmer was listed as the only seller. The insured filed a claim for crop losses but the claim was denied because the insured was not listed as the crop seller. Even after the joint operation was explained to the defendant insurance company, the claim was still denied. The plaintiffs filed for breach of contract, bad faith denial of the claim and reformation of the contract. The court held that the action was not preempted by the federal crop insurance law because the action involved the contract between the parties and not elements of the federal law. The court granted summary judgment on the claim that the defendant was estopped from denying the claim because of representations made by the insurance agent. The court noted that the policy was unambiguous that it covered only the named insured and only the insured's interest in the crop. The court denied summary judgment for the defendant because issues of fact remained as to whether the parties had made a mutual mistake as to the insurance coverage. In addition, the court denied summary judgment for the defendant on the issue of bad faith denial of the claim, holding that issues of fact remained whether the defendant reasonably denied the claim as to the insured after learning about the insured's interest in the crop. **Buchholz v. Rural Community Ins. Co., 2005 U.S. Dist. LEXIS 30059 (W.D. Wis. 2005)**.

PACKERS AND STOCKYARDS ACT. The U.S. Supreme Court has denied certiorari in the following case. The plaintiff was a contract grower of broiler chickens for the defendant. Although the parties had several years of successful dealings, the plaintiff charged that the defendant improperly terminated the contracts