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LEASING FARM PROPERTY

by Neil E. Harl*

The rules governing the leasing of farm and ranch property have gone through an enormous transformation over the past 20 years.1 In the 1970s, the Internal Revenue Service developed a set of guidelines for distinguishing leases from various kinds of purchase arrangements.2 Those authorities gave way to "safe harbor" leasing in 1981 and "farm finance" leases in 1982. Those provisions have now been repealed or have expired so that the determination of what is a lease is governed by pre-1981 law.

Rules applicable in 1981-87. As part of the Economic Recovery Tax Act of 1981, Congress enacted a relaxed set of rules for characterizing arrangements as leases or purchase arrangements.3 Under those provisions, a corporate lessor could enter into a lease arrangement that treated the lessor as the owner of the property for purposes of claiming cost recovery deductions and investment tax credit.4 Dubbed "safe harbor" leasing, the 1981 rules led to widespread abuse and were amended substantially in 1982.5 The 1982 legislation created a new concept, "finance leases" and repealed, with some exceptions, safe harbor leasing effective for leases entered into after December 31, 1983. The Tax Reform Act of 1984 postponed, for four years, the effective date for finance lease rules and extended the farm finance lease provisions through 1987.6 The finance lease rules were finally repealed in 1986, except for transitional rules, which continued farm finance lease provisions through 1987.7 Since 1987, leases have been subject to the pre-1981 rules.

Rules applicable since 1987. As indicated, repeal of the finance lease provisions returned leasing to the pre-1981 guidelines. Before enactment of the safe harbor and finance lease provisions, property leasing took place under rules less certain and less well-defined than the statutory concepts enacted in the 1980s. The pre-1981 rules emphasized the economic substance of lease arrangements. To be characterized as a lease, the arrangement had to be, in substance, a lease and not a mere financing arrangement or some type of conditional sale. An important motive for leasing, historically, has been that the annual lease deduction may exceed the sum of annual deductions for depreciation, interest, repairs, taxes and insurance, which are allowable in a purchase transaction. Hence, taxpayers have been motivated to enter into arrangements that were denominated leases but in reality were camouflaged sales.

The Internal Revenue Service, over several years, had provided several guidelines for determining whether arrangements would be characterized for federal income tax purposes as leases8—

- The lessor must have a 20 percent unconditional at-risk investment in the property.9 That minimum investment must be maintained throughout the lease term and exist at the end of the lease.10
- Neither the lessee nor a party related to the lessee may furnish any part of the property to any party is treated as a contract right of the lessee to cause the property to purchase the property.16 Thus, such a provision could preclude an arrangement being treated as a lease.

This condition is easily the most serious limitation on drafting leases. Many lessees want a firm assurance that all or a substantial part of the lease payments will be credited on the purchase price for the leased property.

- The lessor must expect to receive a profit and a positive cash flow from the transaction independent of tax benefits.17
- Property that is usable only by the lessee (limited use property) may not be eligible for lease treatment.18 IRS will not issue advance rulings on whether certain transactions purporting to be leases of property are leases for federal income tax purposes where the property is limited use property.

The concern of IRS is that, for limited use property, there will probably be no potential purchasers or lessees at the end of the lease term other than the lessee who has been leasing the property.19 therefore, the lessee is assured of the benefits of the property over the entire useful life of the property.

Trades of property for leased replacements. Frequently, a farmer or

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rancher wishing to lease a piece of equipment has an item to trade in. This can create significant income tax problems if handled as a single transaction — a trade in of the used item and a leasing of the replacement.

The problem is that a trade is a tax-free exchange only if it is "held for productive use in a trade or business or for investment" and is exchanged "solely for property of like kind." An exchange of a tractor for the lease of a replacement tractor, for example, does not appear to be a like kind exchange. Therefore, a trade of a used tractor for a lease of a replacement tractor is likely to be treated as a sale of the used tractor and a lease of the replacement. Such a characterization would require recognition of gain or loss, recapture of depreciation and recapture of investment tax credit on the trade in and a recalculation of the lease payments for income tax purposes. Quite clearly, the better approach, at least from the standpoint of simplicity, is to handle such trades as two separate transactions — (1) a sale of the used equipment to the dealer and (2) a lease of the replacement item.

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**Footnotes**

1 See generally 4 Harl. Agricultural Law § 29.05[2][d] (MB 1989).
4 Id.
8 See note 2 supra.
11 Id. at 716.
12 Id.
13 Id.
14 Id.
15 Id.
16 Id.
17 Id.
19 Id.
20 I.R.C. § 1031(a).
21 See Treas. Reg. § 1.1031(a)-1 (lease of 30 years or more of real property considered like kind in exchange for real property).

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**DEVELOPMENTS IN PERSPECTIVE**

**PREEMPTION OF STATE EXEMPTIONS FOR EMPLOYMENT PLANS BY ERISA**

A number of cases have been published recently involving the issue as to whether the Employee Retirement Income Security Act (ERISA), 29 U.S.C. § 1144(a), preempts state exemptions for employment plans and prevents such exemptions from being used at the state and federal levels.

The source of the issue is the U.S. Supreme Court case, Mackey v. Lanier Collections Agency & Service, Inc., 486 U.S. 825, 108 S. Ct. 2182, 100 L.Ed.2d 836 (1988), which held that a Georgia anti-garnishment statute was unconstitutional because the subject of the statute was preempted by ERISA § 514(a), 29 U.S.C. § 1144(a). The Georgia statute expressly prohibited garnishments of ERISA plans, except in the cases of alimony or child support. Mackey, however, did not involve a bankruptcy exemption.

Although one Texas Bankruptcy Court judge has ruled that ERISA did not preempt the Texas exemption of ERISA plans, In re Volpe, 100 B.R. 840 (W.D. Texas 1989) (Kelly, B.J.), other Texas Bankruptcy Court judges and Arizona and Mississippi Bankruptcy Courts have held state ERISA plan exemptions preempted by ERISA based upon the ruling in Mackey. In re Komet, 104 B.R. 799 (Bankr. W.D. Tex. 1989), aff’g point on rehear’g 93 B.R. 498 (Bankr. W.D. Tex. 1988) (Clark, B.J.); In re Flindall, 105 B.R. 32 (Bankr. D. Ariz. 1989); In re Larson, 102 B.R. 85 (Bankr. N.D. Tex. 1989); In re McLeod, 102 B.R. 60 (Bankr. S.D. Miss. 1989); In re Dyke, 99 B.R. 343 (Bankr. S.D. Tex. 1989).

The issue of whether ERISA preempts employment plan exemptions of other states has yet to be tried. The U.S. Supreme Court in Mackey stated:

"ERISA § 514(A) preempts 'any and all State laws insofar as they may now or hereafter relate to any employee benefit plan' covered by the statute."

ERISA governs:

"Any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund or program—

(i) provides retirement income to employees, or

(ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond, regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan." 29 U.S.C. § 1002(2)(A).

Under this broad definition and Mackey, most state employment plan exemptions would be preempted by ERISA.

Note: Two courts have held that ERISA does not preempt state IRA exemptions. In re Laxson, 102 B.R. 85 (Bankr. N.D. Tex. 1989) (Texas IRA exemption not preempted by ERISA); In re Martin, 102 B.R. 639 (Bankr. E.D. Tenn. 1989) (Tennessee IRA exemption not preempted by ERISA).

Debtors have argued, without much success, that although ERISA preempts state exemptions for employment pension plans, ERISA itself is a federal exemption allowed under 11