Federal Tax Update

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ditures that are not capital in nature. Thus, for fertilizer, lime and other soil amendments applied in the year of crop use, with no significant carryover to a later year, an election should not be required. The problem is that there is almost always some carryover.

**FOOTNOTES**

2. I.R.C. §§ 175, 180, 182 (repealed in 1986).
8. I.R.C. § 180(a).
10. *Id.*
15. Treas. Reg. § 1.175-3. See Maple Leaf Farms, Inc., 64 T.C. 438 (1975), *acq.*, 1975-2 C.B. 2 (to be considered in business of farming, farm owner must participate to significant degree in growing process and must be at substantial risk of loss from growing process); Ltr. Rul. 8724003, January 30, 1987 (expenditures not deductible where farm cash rented and managed by third party manager).
19. *Id.*
20. *Id.*

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**FEDERAL TAX UPDATE**

by Neil E. Harl

**AUTOMOBILE TRADES**

Practitioners have raised a question about the handling of trades involving automobiles used for both business and personal use under the listed property rules. The IRS position is detailed in IRS Pub. 917, "Business Use of a Car" (Rev. Nov. 1988). The following examples illustrate both the IRS approach and another approach (keep in mind that examining agents are more likely to look for adherence to the IRS approach).

**Example**

On April 15, 1987, Elmer Fudd purchased and placed in service a new Cadillac with a purchase price of $28,000. The automobile is used 40 percent in the farm business and 60 percent for personal use. Because business use is less than 51 percent, no expense method depreciation is claimed. For vehicles placed in service during 1987, depreciation is limited to $2,560 the first year, $4,100 for the second year, $2,500 for the third year and $1,475 for each succeeding year. On January 2, 1996, Fudd trades the automobile for a new Cadillac and pays $17,500 in cash. At that time, the Cadillac traded in has a fair market value of $14,000.

### IRS APPROACH

<table>
<thead>
<tr>
<th>Cost</th>
<th>$28,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less depreciation claimed (figured at 100% business use)</td>
<td></td>
</tr>
<tr>
<td>1987</td>
<td>$2,500</td>
</tr>
<tr>
<td>1988</td>
<td>$4,100</td>
</tr>
<tr>
<td>1989</td>
<td>$2,550</td>
</tr>
<tr>
<td>1990</td>
<td>$1,474</td>
</tr>
<tr>
<td>1991</td>
<td>$1,475</td>
</tr>
<tr>
<td>1992</td>
<td>$1,475</td>
</tr>
<tr>
<td>1993</td>
<td>$1,475</td>
</tr>
<tr>
<td>1994</td>
<td>$1,475</td>
</tr>
<tr>
<td>1995</td>
<td>$1,475</td>
</tr>
<tr>
<td>1996</td>
<td>$738</td>
</tr>
<tr>
<td>Total depreciation</td>
<td>$18,798</td>
</tr>
</tbody>
</table>

Depreciation actually claimed

40% x $18,798 = $7,519

Adjusted basis of old automobile

$20,481

### BASIS OF NEW AUTOMOBILE FOR DEPRECIATION

| Adjusted basis of old auto | $20,481 |
| Plus boot paid | $17,500 |
| Basis before adjustment | $37,981 |
| Less depreciation attributable to personal use | $18,798 |
| - $7,519 | $11,279 |
| Basis for depreciation | $26,702 |

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*Special acknowledgement to Philip E. Harris, University of Wisconsin-Madison.*
With this approach, the income tax basis of the personal use of the automobile is reduced by the depreciation amount attributable to the personal use portion of the vehicle. It seems strange to be reducing the basis of personal use property by the amount of depreciation which would have been allowable had it been a business asset.

**ANOTHER APPROACH**

The other approach would involve separating the vehicle into two components—one for personal use and one for business use.

Income tax basis of automobile traded in on January 2, 1996–

- **Business portion (original basis)** $11,200
  - Less depreciation claimed 7,519
  - 3,681
- **Personal portion (original basis)** $16,800
  - Less depreciation 0
  - Fair market value on trade 8,400
  - Basis on trade 8,400
- **Basis of vehicle traded in** $3,681
  - + 8,400
  - $12,081
- **Plus boot paid** $17,500
- **Basis of automobile acquired 1/2/96** $29,581

Whether one gains or loses from this approach (compared to the IRS approach) depends upon the fair market value of the auto at the time of the trade. The two approaches are obviously quite different. Note that the first set of calculations above represents the stated IRS position.

* * *

**ERRORS IN THE FARMERS TAX GUIDE IRS PUB. 225 (1989)**

1. On page 6, left column, the publication states, "unless you are a limited partner, your distributive share of income from a partnership is self-employment income." In various situations, including that of retired partners under Treas. Reg. § 1.1402(a)-17, distributive shares are not self-employment income.

2. On page 2, middle column, it is stated that "gross income from farming does not include . . . 2) Gains from sales of livestock held for draft, breeding, sport, or dairy purposes. . . ." The content of the statement is that the authors are trying to define Schedule F income, not gross income. Gains from the sales of livestock held for draft, breeding, sporting or dairy purposes are clearly included in gross income for purposes of calculating estimated tax. Rev. Rul. 63-26, 1963-1 C.B. 295, mod. by Rev. Rul. 80-366, 1980-2 C.B. 343 (Section 175 meaning of "gross income" does not necessarily apply in all respects for estimated tax purposes). As "gross income" is defined for purposes of I.R.C. § 175, soil and water conservation expense (and used elsewhere by specific reference to I.R.C. § 175), income from livestock held for draft, dairy, breeding or sporting purposes is included. Treas. Reg. § 1.175-5(a)(2).

3. On page 66, right column, it is recited that the taxpayer in the example deducted the costs of raising breeding and dairy cows, thus making an election not to capitalize the costs for raised replacement dairy and beef animals as required by I.R.C. § 263A for the years 1987 and 1988. Yet the depreciation record on page 72 shows double declining balance depreciation and 150 percent declining balance depreciation claimed on some property acquired in 1987 and 1988. Such is not permissible. The taxpayer is limited to alternative depreciation for all property placed in service in the taxable year the election out is in effect. I.R.C. §§ 263A(e)(1), (e)(2)(A). See Temp. Treas. Reg. § 1.263A-1T(c)(6)(vi)(B).

4. On page 78, the Form 4797 shows that a raised heifer was sold on August 1, 1989, and was reported in Part I of Form 4797 (for property used in a trade or business and held long enough to merit the long-term capital gain treatment). Because the heifer was used in a farm business where the election had been made not to capitalize costs, the animal is subject to I.R.C. § 1245 recapture; thus, the gain should not be reported in Part I of Form 4797. Rather, gain from the raised heifer would be properly reported in Part III of Form 4797.