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New Rules In Handling Trades

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NEW RULES IN HANDLING TRADES

— by Neil E. Harl*

In a Notice[1] which has received relatively little attention, the Internal Revenue Service on January 4, 2000, issued new guidance on handling depreciation following a like-kind exchange[2] or involuntary conversion.[3] Thus, the new rules apply to machinery and equipment trades, like-kind exchanges of farmland and other property and reinvestment following a fire or other involuntary conversion.

The previous rule—like-kind exchanges

For decades, the accepted practice for depreciation on business property acquired in a like-kind exchange was to add the unrecovered income tax basis in the item traded in to the cash boot paid and subtract the cash or other unlike property received.[4] The entire basis amount on the acquired property was then subject to depreciation based on the classification of the acquired asset.

Example: A farmer trades a 1996 tractor which had been depreciated down to $18,000 for a new 2000 tractor on August 1, 2000, and pays $92,000 in cash. The adjusted income tax basis for the new tractor would be $18,000 + $92,000 or $110,000. That amount would be entered on the depreciation schedule with the $92,000 eligible for expense method depreciation[5] and the remaining amount of the cash boot paid plus the basis carried over from the item given up in the exchange would be eligible for regular depreciation.

Example: In the above example, if $20,000 were claimed in expense method depreciation,[6] the remaining $72,000 of cash boot plus the $18,000 carried over in the trade or $90,000 would be eligible for regular depreciation.

The previous rule—involuntary conversions

For involuntarily converted property, whether by destruction, theft, seizure or condemnation,[7] no gain is recognized if the property acquired is similar or related in service or use to the property involuntarily converted.[8] The basis of the acquired property is derived from the basis of the involuntarily converted property, decreased by the amount of money received by the taxpayer which is not reinvested and increased by the amount of cash paid or gain recognized.[9]

> *Example*: A nearly new combine with an income tax basis of $120,000 is totally destroyed by fire. The owner collected $125,000 from insurance and paid an additional $20,000 in cash to acquire a new combine. The new combine would be entered on the depreciation schedule with an income tax basis of $145,000 (for purposes of expense method depreciation and regular depreciation).

The amount eligible for regular depreciation is based on the classification and other features of the property acquire.

The new rules

In an exchange of MACRS for MACRS property, the acquired MACRS asset is depreciated over the remaining recovery period and using the same depreciation

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method and convention as the exchanged (or involuntarily converted) property *with respect to so much of the taxpayer's basis in the acquired property as does not exceed the taxpayer's basis in the property given up.*[10] To the extent basis in the acquired property exceeds the income tax basis of the exchanged property, the acquired property is treated as newly purchased MACRS property.[11] Thus, two separate depreciation deduction schedules are needed—one for the carryover basis over the remaining recovery period and one for the portion of the basis attributable to the cash paid which is depreciated as newly purchased property over the recovery period for the acquired asset.

Example: Returning to the above example of a trade of a 1996 tractor (which had been depreciated down to $18,000) for a new 2000 tractor with a $92,000 cash payment, the $18,000 amount continues to be depreciated as seven-year property beginning with the date the 1996 tractor was placed in service, using the depreciation method and convention as had been used for the 1996 tractor.

The $92,000, less any amount claimed as expense method depreciation, would be entered for the 2000 tractor as a newly purchased asset. Thus, the new tractor would be depreciated under the recovery period, convention and depreciation method appropriate for a tractor placed in service on August 1, 2000. Thus, the taxpayer's depreciation schedule would now reflect two entries. One entry, in effect, reflects the continuing depreciation on the tax investment in the 1996 tractor. The other entry would show the new tax investment in the 2000 tractor.

Effective date

For acquired MACRS property placed in service on or after January 3, 2000, the principles in Notice 2000-4[12] must be followed.

Property placed in service before that date, for which the entire basis for the acquired property is treated as newly purchased property, can continue with that approach.[13] For such property to be shifted to Notice 2000-4 principles is a change of accounting method.[14] Those taxpayers who shift to Notice 2000-4 must have acquired the property in a like-kind exchange or by involuntary conversion, be presently treating the property as newly purchased MACRS property, make the change for the first or second tax year ending after January 3, 2000, and treat the shift as an automatic change of accounting method.[15] If depreciation under Notice 2000-4 results in more depreciation allowable than what was actually taken, the difference is a Section 481 adjustment that must be taken into account under *Rev. Proc. 99-49*.

In conclusion.

The major impact of Notice 2000-4[17] is likely to be in the additional complexity in handling entries on the depreciation schedule. The Notice will have an impact, also, on the timing of depreciation deductions, depending upon the facts of each situation.

FOOTNOTES

1 Notice 2000-4, I.R.B. 2000-3, 1.

2 I.R.C. § 1031. See generally 4 Harl, *Agricultural Law* § 27.03[8][a][ii](2000); Harl, *Agricultural Law Manual* § 4.02[16](2000).

3 I.R.C. § 1033. See generally 4 Harl, supra note 2, § 27.04.

4 I.R.C. § 1031(d). See 4 Harl, supra note 2, § 29.04[1][b].

5 I.R.C. § 179. See 4 Harl, supra note 2, § 29.05[2][b].

6 See I.R.C. § 179(b)(1) (the maximum expense method depreciation for 2000 is $20,000).

7 I.R.C. § 1033(a).

8 I.R.C. § 1033(a)(1).

9 I.R.C. § 1033(b).

10 Notice 2000-4, I.R.B. 2000-3, 1.

11 *Id*.

12 I.R.B. 2000-3, 1.

13 *Id*.

14 *Id*.

15 See Rev. Proc. 99-49, I.R.B. 1999-52, 725.

16 *Id*.

17 I.R.B. 2000-3, 1.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

FEDERAL TAX-*ALM* § 13.03[7].*

DISCHARGE. After losing a Tax Court case which held that the debtor owed taxes, the debtor married his long-time companion and executed an antenuptial agreement which transferred all of the assets of a corporation owned by the debtor to the debtor's spouse's corporation. In return, the spouse transferred to the debtor debts owed to her by the debtor. Neither set of assets had much value because the debtor's corporation had been incurring substantial losses. However, because the debtor's corporation owned the debtor's residence and vehicles, the antenuptial agreement effectively removed from the debtor's estate all assets against which the IRS could levy to satisfy the Tax Court judgment. The IRS petitioned for nondischarge of the debtor on the tax claims for willful and fraudulent attempt to evade taxes. The court held that the tax debt was nondischargeable because the intentional and voluntary transfer of the debtor's assets without adequate consideration to a family member was a willful and fraudulent attempt to evade taxes. On appeal, the appellate court initially reversed, holding that, under *In re Haas, 48 F.3d 1153 (11th Cir. 1994)*, the mere non-payment of taxes did not amount to a willful attempt to evade taxes under Section 523(a)(1)(C). The appellate court had expressed reservations about the wisdom of *Haas* under the facts of this case but felt compelled to follow *Haas*. On

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