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Recommended Citation
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Like-Kind Exchanges With Depreciable Tangible Personal Property

-by Neil E. Harl*

As noted in a recent article in the *Drake Journal of Agricultural Law* on like-kind exchanges involving real property, little change has been made on eligibility issues of real property for like-kind exchange treatment since the beginning of the like-kind concept in 1918.¹ That is not the case with like-kind exchanges involving depreciable tangible personal property where classification systems have been in place for several years. A recent effort to introduce a classification system into real property like-kind exchanges (limiting exchanges of urban property with real property and vice versa) was rejected.

The general rule for depreciable tangible personal property

Under the regulations,² depreciable tangible personal property held for productive use in a trade or business or for investment may be exchanged for property of a like-kind or of like class.³ However, ironically enough the regulations do not define “depreciable tangible personal property.”⁴

As for the role of state law in property classification for like-kind exchange purposes, the United States Supreme Court in 1940 held that “[i]n the application of a federal revenue act, state law controls in determining the nature of the legal interest which the taxpayers had in the property or income sought to be reached by the statute.”⁵ However, the Chief Counsel’s Office has ruled that federal law controls over the state classification to determine whether an exchange of properties is like-kind.⁶

“Depreciable tangible personal property” is defined elsewhere in the Internal Revenue Code, including investment tax credit⁷ and recapture of depreciation,⁸ with other areas of tax law referring back to the investment tax credit definition.⁹ That source states -

“...local law shall not be controlling for purposes of determining whether property is or is not ‘tangible’ or ‘personal.’ Thus the fact that under local law property is held to be personal property or tangible property shall not be controlling. Conversely, property may be personal property for purposes of the investment credit even though under local law the property is considered to be a fixture and therefore real property.”¹⁰

Some have felt that those regulations leaned slightly toward a broader definition of “depreciable tangible personal property” inasmuch as investment tax credit was at stake and the right to elect was the gateway to claiming investment tax credit which was viewed favorably in terms of economic policy. The cases and rulings tend to reflect that orientation well.

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Classification of depreciable personal property assets

The regulations currently in effect specify that personal property is divisible into classes with two sets of classes in use, and properties are eligible for like-kind exchange treatment if the properties are of the same general asset class or the same product class. Property cannot be classified within more than one general asset class or more than one product class. Moreover, property classified in a general asset class may not be classified within a product class.

General asset classes. Depreciable tangible personal property is classified within 13 general asset classes. The classes are listed in the IRS Publication for determining classification for depreciation purposes as asset classes 00.11 through 00.28 and 00.4. The general asset classes are (1) office furniture, fixtures and equipment; (2) information systems; (3) data handling equipment; (4) airplanes; (5) automobiles and taxis; (6) buses; (7) light general purpose trucks; (8) heavy general purpose trucks; (9) railroad cars and locomotives, except those owned by railroad transportation companies; (10) tractor units for use over-the-road; (11) trailers and trailer-mounted containers; (12) vessels, barges, tugs, and similar water transportation equipment except those used in marine construction; and (13) industrial steam and electric generation and/or distribution systems. It does not take much perspicacity or insight to conclude that the 13 general asset classes are not very helpful in farm and ranch settings.

Four or six digit product classes. Depreciable tangible personal property that is not classified within any general asset class is classified into four or six digit product classes. IRS released guidance for using the North American Industry Classification Manual (NAICS Manual) for federal income tax purposes on August 12, 2004. The regulations adopted Sectors 31 through 33 of the NAICS Manual for defining product classes using six digit product classes. The four digit class system continues to be used until the regulations for six digit classification become final.

Properties within the same product class generally are of a like class and are eligible for like-kind exchanges. For example, much of the personal property used in a farm business is either included in four digit class 3523, Farm Machinery and Equipment, under the SIC system, or 333111 under the six digit product class. Thus, it is permissible to exchange, in a like-kind exchange, any item of farm machinery and equipment for any other item of farm machinery and equipment. The NAICS system, product class 333111, specifically lists combines, cotton gin machinery, feed processing equipment, planters, plows, farm tractors, haying machinery, milking machines and poultry feeding and watering equipment. In short, an exchange of farm machinery for farm machinery is like-kind.

Livestock are a different story. Each type of livestock has its own classification system number. For example (and there are many, many different classifications of livestock) beef cattle are listed as class 0212 for the four digit classification, 112111 in the six digit system; hogs are 0213 in the four digit class, 112210 for the six digit system, dairy cattle are 0241 for four digit purposes, 112120 under the six digit scheme.

In conclusion

The classification systems are in a stage of transition; however it is relatively clear how farm property is viewed. What is not clear is when the Internal Revenue Service will embrace the entire six digit classification system.

ENDNOTES

2 Treas. Reg. § 1.1031(a)-(2)(b)(1).
4 See Treas. Reg. § 1.1031(a)-(2)(1).
5 Morgan v. Comm’r, 309 U.S. 78, 82 (1940). See Peabody Natural Resources v. Comm’r, 126 T.C. 261 (2006). See also Harl, “What is ‘Like-Kind’ for Real Estate?” 17 Agric. L. Dig. 177 (2006); TAM 200424001, December 8, 2003 (railroad track which was laid (real property under state law) was not like-kind to unassembled track which was personal property; real and personal property can never be like-kind with each other).
6 CCA 201238027, April 17, 2012.
7 Treas. Reg. § 1.1245-3(b).
8 Treas. Reg. § 1.1245-3(b).
9 Treas. Reg. § 1.1245-3(b).
10 Treas. Reg. § 1.1031(a)-(2)(b).
11 Treas. Reg. § 1.1031(a)-(2)(b)(2).
12 Treas. Reg. § 1.1031(a)-(2)(b)(2).
14 Treas. Reg. § 1.1031(a)-(2)(b).
17 See Temp. Treas. Reg. § 1.1031(a)-2T(b)(8).
19 Id.