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Recommended Citation
Harl, Neil E. (2016) "Undivided Interests of Farm and Ranch Land In A Like-Kind Exchange (and for Self-Employment Tax, Also)," Agricultural Law Digest: Vol. 27 : No. 14 , Article 1. Available at: http://lib.dr.iastate.edu/aglawdigest/vol27/iss14/1

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Undivided Interests of Farm and Ranch Land In A Like-Kind Exchange (and for Self-Employment Tax, Also)

-by Neil E. Harl-

A 1995 private letter ruling held that an undivided one-sixth interest in farm real estate that was held for productive use in a trade or business or for investment which was exchanged for a 100 percent interest in other farm real estate qualified as a tax-free, like-kind exchange. The exchange involved crop share leases. The letter ruling did not state whether it was a material participation crop share lease or a non-material participation crop share lease. The letter ruling recites the basic requirements for a like-kind exchange but did not anticipate what was to come two years later as the result of another private letter ruling which added another set of requirements as noted below.

But looking just at the like-kind exchange requirements, a material participation crop share or livestock share lease should qualify as “... held for productive use in a trade or business...” and a non-material participation crop share or livestock share lease or a cash rent lease should meet the requirements for being held for “investment,” as required by the like-kind exchange statute.

Whether it is an interest in a “business” entity

The second set of requirements began to take shape in a 1997 private letter ruling which held that co-ownership of rental properties could be deemed a partnership. That ruling involved an exchange of 10 rental properties between two brothers who owned equal co-ownership interests in the arrangement. The brothers, for five consecutive years, had reported all income and losses on a Form 1065, partnership return, which IRS found objectionable. The brothers, however, argued that the use of the Form 1065 was a mere convenience and should not be interpreted as an indication that the arrangement was a partnership.

The Internal Revenue Service, relied heavily on Treas. Reg. § 301.7701-1(a)(2), which provides that a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation or venture and the participants divide the profits therefrom. However, the mere co-ownership of property that is maintained, kept in repair and rented or leased does not constitute a separate entity for federal tax purposes. Also, a business is considered an entity with...
two or more members classified for federal tax purposes as either a corporation or a partnership. It should be noted that Rev. Rul. 75-374 had concluded that a two-person co-ownership of an apartment building rented to tenants was not a partnership. All of this led to a rancorous debate for about five years after the release of Ltr. Rul. 9741017 until the issuance of Rev. Proc. 2002-22.

In Rev. Proc. 2002-22, the Internal Revenue Service specified the conditions under which the agency would consider a request for a ruling that an undivided fractional interest in rental real property is not an interest in a business entity, within the meaning of Treas. Reg. § 301.7701-2(c). The procedure applies to co-ownership of rental real property in an arrangement classified under local law as a tenancy-in-common, in the form of a 15-item checklist. The latest case in this area, Methvin v. Commissioner, involved a two to three percent interest in various oil and gas ventures. The Tax Court, in an unusually brief opinion, and the Tenth Circuit Court of Appeals, also in a very brief opinion based entirely on the briefs, relied upon the definition of “partnership” in Treas. Reg. Sec. 301.7701-1(a)(2) and held that the facts were within the definition in the regulations for a “partnership” even though partnership status was specifically excluded by article 14 of the operating agreement. There was no mention in either opinion of the 15-item checklist in Rev. Proc. 2002-22. This could be marking a different approach to the issue of what is a “business.”

So what does this mean for farm and ranch operations?

It would appear to mean that co-ownership of land involving a material participation crop share or livestock share lease, in a like-kind exchange, would meet the requirements for the like-kind exchange. However, it would run the risk of being classified as a “business entity” under Rev. Proc. 2002-22 and be treated as a partnership. On the other hand, land under a cash rent lease would likely escape classification as a “business entity” and meet both sets of requirements. That could be the outcome, also, for a non-material participation share rent lease but that is less certain. Judging from the Methvin case, co-ownership with undivided ownership is likely to be treated the same way for self-employment tax purposes.

It is almost a certainty that all arrangements that could be treated as “partnerships” will be scrutinized. Recent letter rulings confirm that belief.

ENDNOTES

2 I.R.C. § 1031.
4 I.R.C. § 1031(a)(1).
5 Ltr. Rul. 9741017, July 10, 1997 (co-ownership of rental properties deemed a partnership; partnership returns, Form 1065, filed for convenience for five years).
8 Treas. Reg. § 301.7701-1(a)(2).
9 Id.
12 2002-1 C.B. 733.
13 T.C. Memo. 2015-81, aff’d, 2016-1 U.S. Tax Cas. (CCH) ¶ 50,328 (10th Cir. 2016).
14 2002-1 C.B. 733.
15 See I.R.C. § 7701(a)(2).
16 2002-1 C.B. 733.
17 See note 13 supra.
18 See Ltr. Rul. 201622008, Feb. 23, 2016 (sale of tenancy-in-common interest in property in question will not constitute interest in business entity for purposes of eligibility for I.R.C. § 1031 under 15-item check-list). See also Ltr. Rul. 200327003, March 7, 2003 (undivided fractional interest in property eligible for like-kind exchange; not interest in business entity); Ltr. Rul. 200625009, March 1, 2006 (undivided fractional interest not interest in entity; conditions of Rev. Proc. 2002-22, 2002-1 C.B. 733 met). See also Ltr. Rul. 200513010, Dec. 6, 2004 (undivided fractional interest in property was not partnership; involved co-tenancy agreement).