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Price Allocations with Respect to Sales of Farm Property: A Survey of Income Tax Considerations and Planning Possibilities

by

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I. Introduction

Old MacDonald had a farm . . . , and on that farm he had a cow . . . , a duck . . . a ____ (you pick it).[1]

Why a children's song (especially one so truncated) to begin an article concerning taxes? This children's ditty, no doubt unintentionally, correctly implies the nature of a typical "farm" for tax purposes as an aggregate of different properties. More authoritatively, Justice Hand used more precise, if less lyrical,[2] prose in pointing out that a business has to be

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1. *Old MacDonald's Farm*, author unknown, or at least not claiming credit.

2. Sadly, it appears that those who spend too much time in the tax trenches tend to see whatever creative writing talents they may have possessed diminish with time. A poignant case in point concerns the opinion of the Tax Court in Jenkins v Commissioner, 47 T.C.M. (CCH) 238 (1983). Mr. Jenkins, better known to those outside of tax circles as the country music singer, Conway Twitty, had attempted to claim a business deduction under section 162 of the Internal Revenue Code for some debts of a corporation bearing his name which he had repaid although having no legal obligation to do so. The Tax Court found that the payments were deductible, but, apparently seeking the attention of the principal in the case, went further and penned (footnote 14) an *Ode to Conway Twitty*:

Twitty Burger went belly up
But Conway remained true
He repaid his investors, one and all
It was the moral thing to do.

His fans would not have liked it
It could have hurt his fame
Had any investors sued him
Like Merle Haggard or Sonny James.

When it was time to file taxes
Conway thought what he would do
Was deduct those payments as business expense
Under section one-sixty-two.

In order to allow these deductions
Goes the argument of the Commissioner

"comminuted into its fragments" for tax purposes.[3] This conceptual approach, which also applies to the sale of a "farm," can have significant tax consequences when the farm is sold.[4]

Without further resort to song, this Article will attempt an overview of income tax considerations and possible planning opportunities which may arise with respect to sales of farm properties. The primary focus is on the income tax consequences resulting from the manner in which the sales consideration is allocated among the various tax types of property involved in the sale, and thus the model used will be the sale of a "farm" involving more than a single tax type of property.

The discussion will not be limited to dispositions of unimproved farm land, since many sales involve much more.

The payments must be ordinary and necessary
To a business of the petitioner.

Had Conway not repaid the investors
His career would have been under cloud
Under the unique facts of this case
Held: The deductions are allowed.

Perhaps also dreaming of the lights of Nashville, someone in the Internal Revenue Service prepared an internal document, referred to as an Action on Decision, in which another original creative effort appeared, entitled *Ode to Conway Twitty: A Reprise.*

Harold Jenkins and Conway Twitty
They are both the same
But one was born
The other achieved fame.

The man is talented
And has many a friend
They opened a restaurant
His name he did lend.

They are two different things
making burgers and song
The business went sour
It didn't take long.

He repaid his friends
Why did he act
Was it business or friendship
Which is fact?

Business, the court held
It's deductible they feel
We disagree with the answer
But let's not appeal.

As far as can be determined, neither the Tax Court judge nor author in the Internal Revenue Service went on to a career in country music.

3. Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945).

4. *See, e.g.*, Farmer's Tax Guide, IRS Pub. 225, 41-42 (1989 ed.).

For example, the land may contain improvements such as fences, roads, and buildings.[5] In addition, farm machinery, equipment, and livestock may be involved. The tax considerations often vary with the type of property involved.

II. "FARM" AS AN AGGREGATE OF PROPERTIES

Farm properties fit into a variety of types for tax purposes. Properties being sold must be categorized into their respective tax types in order to properly identify the tax consequences to both the seller and the buyer. This categorization is necessary whether a particular farm property is sold separately or as an aggregate of properties. Where properties fitting into multiple tax types are sold together, such as in the sale of a typical "farm," both the *amount* of gains or losses and the *character* (ordinary or capital) of such gains or losses to the seller will generally be determined separately with respect to each type, for tax purposes, of properties being sold.[6] The manner in which the sales price is allocated among the various types of properties being sold thus has a direct bearing on the gain or loss realized with respect to each type of property and thus the overall character of the gain or loss. For example, allocation away from assets which would yield ordinary income to assets which would produce capital gain would increase the overall capital gains while reducing the overall ordinary income.

Similarly, the allocation of sales price may have significant consequences to the buyer. The manner of allocation may accelerate or defer the recovery, in a tax sense, of the buyer's investment in the properties purchased.

This need to categorize properties into a variety of tax types may also have *timing* consequences where the sales price is to be paid over one or more years subsequent to the year of

5. *See, e.g.*, Meeker v CIR, 41 T.C.M. (CCH) 1409 (1981), in which a farm was purchased with the following identified improvements to the land: (1) main dwelling, (2) garage, (3) barn, (4) poultry house, (5) two round steel cribs, (6) corn crib and hog house, (7) machine shed, (8) ear corn crib/granary, (9) upright stave silo, (10) steel storage/drying bin, (11) small steel bin, (12) machine shed with attached loafing shed, (13) west cattle shed, (14) tenant house, (15) west machine shed, (16) miscellaneous sheds, (17) L.P. gas storage tanks, (18) concrete feeding floors, (19) fencing, (20) field tile, (21) three deep wells.

6. Rev. Rul. 55-79, 1955-1 C.B. 370; *Williams*, 152 F.2d at 570.

sale. Since the sale may involve multiple properties of differing tax types, it may also be necessary to allocate the payments to be received among the properties sold. The manner in which these payments are allocated may accelerate or defer gains recognizable by the seller and accelerate or defer the tax recovery of the purchaser's costs. The primary focus of this Article is concerned with price allocation rather than payment allocation issues.

III. THE SELLER—IN GENERAL

A. Overview of Necessary Tax Determinations of the Seller

A farmer who contemplates a sale of farm properties will usually have to make three primary tax determinations in order to properly assess the tax consequences and planning opportunities for income tax purposes: (1) A determination of the *amount* of any recognizable tax gains or losses which will result from the contemplated dispositions; (2) a determination of tax *character* (ordinary or capital) of any such gains or losses; and, (3) a determination of the proper *timing* of the reporting for tax purposes of such gains or losses.

There may also be a concern with peripheral income tax issues, such as possible investment tax credit recaptures and disallowance of deductions with respect to the sale of an unharvested crop.[7]

B. Overview of Basic Tax Goals of the Seller

The farmer who sells property will usually have several income tax goals. These goals will vary depending on whether a tax gain or loss is expected with respect to the particular properties involved in the sale.

7. The Tax Reform Act of 1986 repealed the regular investment tax credit with respect to property placed in service after December 31, 1985. Tax Reform Act of 1986, Pub. L. No. 99-514, § 211(a), 100 Stat. 2085 (1986)(codified at I.R.C. § 49 (1988) [hereinafter TRA 1986]. However, some property placed in service during 1985 may still be within the five-year recapture period specified in section 47(a)(5), and thus potentially subject to recapture if sold before 1991. As to the disallowance of deductions with respect to the sale of an unharvested crop, see *infra* notes 170-73.

1. Gains Expected

To the extent tax gains are expected with respect to particular types of property, the goals may include the following: (1) Maximizing the amount of gains, if any, that will qualify for *nonrecognition*—i.e., will not be currently taxed—under various provisions of the Code; (2) maximizing the amount of gains which will qualify as capital gains and minimizing the gains which must be reported as ordinary income; and, (3) deferring the reporting of recognizable tax gains until future taxable years in order to defer and perhaps reduce any tax costs associated with the gains.

2. Losses Expected

To the extent losses are expected with respect to particular types of property, the selling farmer's tax goals are generally reversed and usually include the following: (1) Maximizing recognition of any losses in order that they may be deductible by the seller and thus produce a current tax benefit; (2) maximizing the amount of recognizable losses which will be reportable as ordinary losses and minimizing the losses which must be reported as capital losses; and, (3) insuring that recognizable losses will be reportable—i.e., deductible—as soon as possible in order to accelerate any tax benefits which will result from the deduction.

IV. THE PURCHASER—IN GENERAL

A. Overview of Tax Considerations of the Purchaser

The well-advised purchaser of farm property will usually have as an overriding tax goal the structuring of the purchase in a manner which will allow the purchaser to recover, in a tax sense, the purchaser's cost as quickly as possible. This tax "recovery" takes place in two basic ways.

(1) Some parts of the purchaser's cost may generate tax deductions which the purchaser can use to offset income and thus reduce income tax liability. These deductions may be "current" deductions, meaning the deductions will generally be taken when the deductible expense is paid or incurred. Alternatively, deductions with respect to some costs may only be

taken incrementally over several years through depreciation or amortization.

(2) Some parts of the cost may serve as the purchaser's tax "basis" in particular assets which the purchaser can "recover," in a tax sense, to the extent not previously deducted, at the time of subsequent disposition of those particular assets by the purchaser.

B. Overview of Methods to Accomplish Purchaser's Goals

There are at least three allocations which will tend to accomplish this overall goal of accelerating the tax recovery of the purchaser's costs.

(1) Allocating as much of the purchase price as possible to costs which will generate current deductions will accomplish this goal. For example, if part of what is being purchased is unused farm supplies of the seller, the amount of the purchase price allocated to these supplies will generally generate a current business deduction to the purchaser if the supplies will be used in the purchaser's farming business.[8]

(2) If some of the assets will be resold quickly, allocation of purchase price to those assets will generate a quick tax recovery through offset against the subsequent sales price of those assets. For example, if the purchase includes harvested grain which the purchaser will quickly resell, tax recovery of any purchase price allocated to the grain would be delayed only until the grain is resold.

(3) To the extent that the purchase price will be allocated to become part of the basis of assets which will not be quickly resold, tax recovery will be expedited if the allocations are to depreciable assets with the shortest "recovery periods" for depreciation purposes. For example, the cost of farm equipment can generally be depreciated over seven years, while the cost of a general purpose barn must generally be depreciated over twenty years.[9] In addition, the cost of land, apart from any structures or improvements on such land, cannot be depreciated at all, and the purchaser would want as

8. *See infra* note 146 and accompanying text.

9. *See infra* notes 126 and 132 and accompanying text.

little as possible of the purchase price allocated to a nondepreciable asset which is expected to be held for a long term.[10]

V. BASIC METHODS TO ACCOMPLISH TAX GOALS

Most of the opportunities to accomplish the tax goals of the seller and the buyer with respect to multiple asset sales will be presented by the flexibility which may be available in making allocations of the sales price among the assets and, where some payments will be made after the year of sale, allocating the payments to be received among the assets sold. These allocations will generally be addressed in drafting two clauses or sets of clauses in the contract of sale or exchange: (1) The "price" clause(s) in which the selling price is allocated among the various properties being sold; and, (2) the "payment" clause(s) in which the terms of payment are described. As previously indicated, the primary focus of this Article is on price clause issues.[11]

B. Allocation of Sales Price

Where a sale involves multiple assets, the consideration being received must be allocated among the assets being sold in order to determine the amount of gain or loss with respect to particular assets. The amount of the gain or loss which results with respect to a particular asset is then characterized according to the nature of the asset involved.[12]

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10. *See infra* note 146 and accompanying text.

11. The payments clause(s) describes the terms of the purchaser's payment(s) of the purchase price. This clause may provide for payments over a period of taxable years which would accomplish the seller's goals of deferring and spreading out the reporting of any recognizable gains.

Where the seller expects a gain, the payments clause will usually present less potential conflict between seller and purchaser than the price clause. The seller may want to spread out payments over more than one taxable year in order to defer and spread out the reporting of any gain recognized under the installment method. *See* I.R.C. § 453 (1988). The purchaser will usually have less reason to object, from a tax standpoint, to deferring payments (and may desire to do so for nontax reasons), since the purchaser's tax consequences are not as significantly influenced as the seller's by the timing of such payments. An exception would be the purchase of assets whose payments will generate a current deduction. *See* Treas. Reg. § 1.461-1(a)(1) (as amended in 1967). Cost allocated to depreciable property will generally become part of the depreciable basis in that property even before the cost is fully paid. *See* Crane v. Commissioner, 331 U.S. 1, 11-12 (1947).

12. *See supra* notes 3-6 and accompanying text.

1. Determining Amount of Gain or Loss

The gain or loss with respect to a particular asset is determined by comparing the "amount realized" to the seller's "adjusted basis"[13] in that same asset. Gain results to the extent the amount realized exceeds the seller's adjusted basis in the asset.[14] Conversely, a loss results to the extent the amount

13. The owner's initial "basis" in property will generally fall into one of four categories:

(1) A "cost" basis, which results when property is acquired by purchase and/or construction. I.R.C. § 1012(a) (1988). The "cost" generally includes the amount paid in cash or other property. Treas. Reg. § 1.1012-1(a) (as amended in 1980). The cost of construction will generally include the cost of labor, materials, and overhead. *See* Treas. Reg. § 1.263(a)-1(a)(1)-2(a) (as amended in 1987). The purchaser's cost also includes the seller's liabilities which the buyer assumes and the amount of any nonrecourse mortgage to which the transferred property is subject. *See Crane*, 331 U.S. at 1.

(2) A "transferred" basis, such as where property is acquired by gift (I.R.C. § 1015(a)) or acquired in a tax-free manner by a partnership from a partner (I.R.C. § 723) or by a corporation from a shareholder (I.R.C. § 362(a)(1)). A transferred basis exists where a transferee's basis is, in whole or in part, the same as that of the transferor. *See* I.R.C. § 7701(a)(43) (1988).

(3) An "exchanged" basis, which generally exists in an exchange of properties where the basis of the property received in the exchange is, in whole or in part, the same as the basis of the property exchanged. I.R.C. § 7701(a)(44) (1988). *See, e.g.*, I.R.C. § 1031(d) (1988) (relating to the basis of property received in a tax-free exchange of properties).

(4) A "stepped" basis, which generally occurs with respect to property received from a decedent. The basis of such property will generally be equal to the value at which the property was included in the decedent's estate for Federal estate tax purposes, usually the fair market value on the date of the decedent's death. I.R.C. § 1014(a) (1988).

The primary "adjustments" made to the initial basis in arriving at the "adjusted" basis for determining gain or loss on a sale or exchange are increases for capital improvements made with respect to such property after acquisition (I.R.C. § 1016(a)(1)) or decreases resulting from allowable deductions with respect to the basis, such as for depreciation or amortization. I.R.C. § 1016(a)(2) (1988). Other adjustments of particular significance with respect to farm land would include additions to basis for soil and water conservation expenses which the farmer does not elect to deduct under section 175 (Treas. Reg. § 1.175-1) and additions for land-clearing expenditures to the extent not deducted under section 182 before its repeal by the Tax Reform Act of 1986. Treas. Reg. § 1.182-1 (1965). If farm land is sold with an unharvested crop on it, the expenditures attributable to the production of the crop are generally added to the basis of the crop (for purposes of determining gain or loss on the sale) rather than deducted as ordinary business expenses. I.R.C. §§ 268, 1016(a)(11) (1988). If a farmer elects under section 77 to include the proceeds of a loan from the Commodity Credit Corporation in income for the year in which received, the farmer's basis in any pledged commodities is increased by the amount of the loan included in income. I.R.C. § 1016(a)(8) (1988).

14. I.R.C. § 1001(a) (1988).

realized is less than the seller's adjusted basis.[15] The seller's adjusted basis in a particular asset will be determined by events preceding the sale.[16] On the other hand, the amount realized with respect to a particular asset will depend on how much of the consideration to be received by the seller is allocated to a particular asset.

2. Amount Realized

The "amount realized" on the sale or other disposition of property is, in general terms, the sum of any money and the fair market value of any property to be received (or deemed received) as consideration for the transfer.[17] The seller's amount realized also includes real property taxes with respect to the property being sold which the purchaser pays or agrees to pay and which are treated by section 164(d) as imposed on the seller.[18] In that situation, such taxes become a part of the purchaser's cost in the property to which the taxes relate.[19]

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15. *Id.*
16. *See supra* note 13.
17. I.R.C. § 1001(b) (1988).
18. *Id.*
19. Treas. Reg. § 1.1012-1(b) (as amended in 1980). If the seller pays or agrees to pay real property taxes attributable to the "real property tax year" in which the sale occurs, the seller's amount realized does not include reimbursements from the buyer for real property taxes treated by section 164(d) as imposed on the buyer. I.R.C. § 1001(b)(1) (1988); Treas. Reg. § 1.1001-1(b)(1) (as amended in 1972). These reimbursements are also *not* a part of the buyer's cost basis in the property. I.R.C. § 1012 (1988); Treas. Reg. § 1.1012-1(b) (as amended in 1980). An exception exists where the seller in a taxable year before the taxable year of sale pays an amount representing real property taxes which are treated under section 164(d) as imposed on the buyer *if* the seller has elected to capitalize such taxes under the provisions of section 266. Reimbursement for such taxes *is* includable in the seller's amount realized.

Section 164(d)(1)(A) generally deems the part of the real property tax allocable to that part of the "real property tax year" which ends on the day before the date of sale as imposed on the seller. The part of the tax allocable to the remainder of the real property tax year which begins on the date of sale is deemed imposed on the purchaser. I.R.C. § 164(d)(1)(B) (1988). The term "real property tax year" means, for this purpose, the period which, under the applicable law (state or local) imposing the particular tax, is regarded as the period to which the tax imposed relates. Treas. Reg. § 1.164-6(c) (1960).

Example: The real property tax year in County R runs from April 1 to March 31. Seller sells real property to Buyer on June 30, 1989. Buyer continues to own the property through March 31, 1990. The real property tax for the real property tax year running from April 1, 1989, through March 31, 1990, is $365. Under section 164(d), $90 (90/365 x $365, 90 days from April 1, 1989, through June 29, 1989) is treated as

Particularly significant is the rule that the seller's amount realized generally includes the amount of liabilities from which the seller is released as a result of the disposition of the property.[20] The seller's amount realized will generally include a recourse obligation which the buyer agrees to pay regardless of whether the seller is thereby released from the liability.[21]

The seller's amount realized also generally includes the amount of a nonrecourse mortgage to which the transferred property is subject.[22] This is generally true even if the value of the property securing the mortgage has declined below the amount of the mortgage at the time of transfer.[23]

If the seller is not a dealer with respect to the property being sold, the amount realized will be reduced by the selling expenses, such as commissions, incurred by the seller.[24] The

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imposed on Seller and $275 (275/365 x $365) is treated as imposed on Buyer. Treas. Reg. § 1.164-6(b)(3) (1960) (Example (1)).

If Buyer in the example agrees to pay the entire $365 real property tax, Seller's amount realized would include only the $90 deemed by section 164(d) as imposed on Seller. That same $90 would also become a part of Buyer's cost basis in the real property purchased. On the other hand, the $90 included in Seller's amount realized, since it is a tax deemed imposed on Seller, would also be deductible by Seller under the provisions of section 164. Similarly, the $275 deemed imposed on Buyer would be deductible by Buyer under the provisions of section 164.

It should be emphasized that the allocation rules relating to real property taxes and the tax consequences which result therefrom apply regardless of whether the contract of sale calls for the purchaser to reimburse the seller for any such real property taxes paid or to be paid by the seller (Treas. Reg. § 1.1001-1(b)(1) (as amended in 1972); Treas. Reg. § 1.164-6(b)(1)(i) (1960)) or whether the contract requires a reduction in sales price for such taxes to be paid by the buyer (Treas. Reg. § 1.1012-1(b) (as amended in 1980); Treas. Reg. § 1.164-6(b)(1)(i) (1960)).

Example: Assume that Seller in the previous example pays the entire $365 property tax bill for the real property tax year in which the sale takes place. Assume the contract of sale specifies a sales price for the real property of $10,000 with no mention of the property tax paid by Seller. Seller's amount realized would be $9,725 ($10,000 - $275) since the sales price would be deemed to include $275 as reimbursement to Seller for the $275 in property taxes paid by Seller which are treated by section 164(d) as imposed on Buyer. Treas. Reg. § 1.1001-1(b)(4) (as amended in 1972) (Example (1)). Similarly, $9,725 would be Buyer's cost basis in the property.

20. Treas. Reg. § 1.1001-2(a)(1) (1980).

21. Treas. Reg. § 1.1001-2(a)(4)(ii) (1980).

22. *See* Crane v. Commissioner, 331 U.S. 1, 12-14 (1947); Treas. Reg. § 1.1001-2(a)(4)(ii) (1980).

23. *See* Commissioner v. Tufts, 461 U.S. 300 (1983); I.R.C. § 7701(g) (1988); Treas. Reg. § 1.1001-2(b) (1980).

24. *See, e.g.*, Black v. Commissioner, 60 T.C. 108, 110-11 (1973). Examples of other selling expenses, incurred by one who is not a dealer in the property sold, which may be offset against the amount realized on the sale of property include expenses for

buyer's equivalent of the selling expenses will generally become part of the buyer's total cost.

If the seller is a dealer with respect to the property being sold, some or all of the selling expenses may be currently deducted as business expenses.[25] Moreover, a nondealer may be able to deduct some of the selling expenses incurred in connection with the sale of a personal residence as a moving expense deduction.[26]

The amount of the sales price which must be allocated among the assets being sold in order to determine gain or loss with respect to each would thus generally be the amount realized as reduced by selling expenses. The buyer's allocable costs would include the buyer's equivalent of the selling expenses.

3. Categorization of Properties into Tax Types

Whenever a sale involves multiple assets falling into different tax types, the assets must be categorized into their respective types in order to determine both the amount of gains or losses and the character (ordinary or capital) of such gains or losses.

The major tax categories of property include:[27] (1) Properties constituting "capital assets" as defined in section 1221—properties falling into this general category would have to be further subdivided between capital assets "held" for more than one year and those held for one year or less;[28]

abstracts of title and revenue stamps (Griffin v. Commissioner, 19 B.T.A. 1243 (1930)), appraisal fees (Ward v. Commissioner, 224 F.2d 547 (9th Cir. 1955), *aff'g* 20 T.C. 332), and legal fees (Gunn v. Commissioner, 49 T.C. 38 (1967)). If gain from the sale of real property will be reported on the installment method, the selling expenses do *not* reduce the selling price. Temp. Treas. Reg. § 15a.453-1(b)(2)(ii) (1981). They are instead added to the seller's adjusted basis for purposes of determining the seller's "gross profit." Temp. Treas. Reg. § 15a.453-1(b)(2)(v) (1981). This has the effect of spreading the recovery of the selling expenses over the installment payments.

25. If the seller is a dealer with respect to the real property being sold, some or all of the selling expenses may be currently deducted as business expenses. *See* Williams v. Commissioner, 25 T.C.M. (CCH) 767, 769 (1966).

26. *See* I.R.C. § 217(b) (1988).

27. *See* Rev. Rul. 55-79, 1955-1 C.B. 370.

28. Capital gains and losses are divided into short- or long-term, depending on whether the asset was held for more than a year at sale (long-term) or one year or less (short-term). I.R.C. § 1222(1)-(4) (1988).

The "holding period" of a taxpayer with respect to particular property generally

(2) properties constituting "property used in the trade or business" as defined in section 1231; and, (3) properties not falling into either of the two previous categories.

Different subdivisions may be necessitated by changes in the tax laws. Within the specific groupings, it may be necessary to further subdivide assets for purposes of computing gain or loss. Some of the assets in the capital asset and "property used in the trade or business" groupings may have ordinary income "recapture" potential which must be accounted for.[29] If a farm includes a house used as the seller's principal residence, any gain with respect to the house may qualify for nonrecognition.[30] Conversely, any loss with respect to the house may not be deductible.[31]

C. Methods of Allocating Sales Price

The Tax Reform Act of 1986 added a new provision to the Code, section 1060,[32] to deal specifically with the allocation of consideration among the assets sold and purchased in any "applicable asset acquisition."[33] This provision governs as to any covered transaction after May 6, 1986.[34] At this point, uncertainties exist as to the scope of its application.[35] However, a brief review of the historical antecedents of the provision is necessary in order to provide a proper context.

1. Background[36]

In general terms, the seller must allocate the sales price

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refers to the period during which the taxpayer has owned the asset. However, section 1223 provides a series of rules for "tacking" other holding periods onto that of the particular taxpayer in the particular asset.

29. *See infra* note 124 and accompanying text.

30. *See infra* note 111 and accompanying text.

31. Treas. Reg. § 1.165-9(a) (1960).

32. TRA 1986, *supra* note 7, § 64.

33. I.R.C. § 1060(a) (1988).

34. TRA 1986, *supra* note 7, § 641(c).

35. *See, e.g.*, Olchyk & Elliott, *Asset-Acquisition Temp. Regs. Leave Many Issues Unresolved*, 69 J. TAX'N 372 (1988), which suggests that the Temporary Regulations issued under section 1060 may extend its scope beyond that intended by Congress.

36. For a thorough review of allocation questions in a farm sales context before the enactment of section 1060 and before the elimination of the investment tax credit and the preferential treatment for long-term capital gains, see Colson, *A Tax View of the Price Clause in Contracts for Sale of Farm Property*, 14 IDAHO L. REV. 297 (1978). Also of interest in providing historical perspective are Schumann, *Farm Sales: Tax*

among the assets sold in accordance with their relative fair market values in order to determine the amount and character of gain or loss with respect to each asset.[37] The buyer must generally also make an allocation of the purchase price in order to establish the proper basis of each asset.[38]

Regulations provide that "fair market value" is a "question of fact."[39] Estate and gift tax regulations define "fair market value" as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."[40] Similar terminology has been used to describe fair market value for income tax purposes.[41] The sales price would of course be the starting point in any allocation.

In farm sales transactions, the parties to the transaction have generally taken one of the following three approaches with respect to the sales price: (1) Allocations of the sales price have been made among the assets under the terms of the sales agreement itself; (2) a total lump sum sales price has been set out for all of the assets involved, with no specific allocations being made among the assets; or, (3) a lump sum price has been set with respect to some assets while specific allocations are made in the agreement with respect to others.

2. Allocation by Agreement

Regulations generally acknowledge that the parties to the transaction, if they are dealing at arm's length, may establish the relative fair market value of various assets by agreement if their tax interests in making the allocations are adverse.[42] Negotiated arm's length allocations were usually accepted by the Internal Revenue Service (IRS) and by the courts where

Considerations, 1 AGRIC. L. J. 629 (1980); Brown, *Sale of a Farm: Negotiations and Price Allocation—Their Income Tax Consequences*, 49 OKLA. B. ASS'N J. 2202 (1978).

37. Rev. Rul. 55-79, 1955-1 C.B. 370.

38. *See* Treas. Reg. § 1.167(a)-5 (1960).

39. Treas. Reg. § 1.1001-1(a) (1972).

40. Treas. Reg. § 20.2031-1(b) (1965); Treas. Reg. § 25.2512-1 (1965).

41. This same definition is cited in the legislative history of section 1060. *See* S. REP. No. 313, 99th Cong., 2d Sess. 252 (1986).

42. *See, e.g.*, Treas. Reg. § 1.1245-1(a)(5) (1971); Treas Reg. § 1.1250-1(a)(6)(i) (1972).

challenged.[43]

The degree of respect paid to an agreed allocation rested largely on the differing tax interests of the seller and buyer. If a particular allocation provided a tax advantage to one party while causing a disadvantage to the other, the IRS was generally content, and in fact would usually seek to hold the parties to their agreement if it were challenged by one of the parties seeking a more favorable allocation.[44]

The differing tax interests which traditionally gave credibility to an agreed allocation depended largely on the traditional tax preference given to long-term capital gains.[45] The seller would generally want as much of any recognized gains as possible to fall into this preferred category and as little as possible to constitute ordinary income. The buyer, on the other hand, would prefer as much as possible of the consideration to be allocated to depreciable assets, preferably assets which also qualified for the investment tax credit. Thus, for example, a farmer may have wanted as much as possible allocated to land in order to increase long-term capital gains while the buyer would object because the cost of the land was not depreciable.[46] Compromises would have to be effected. In the sale of a business with a substantial going concern value, the seller may have wanted a large allocation to goodwill, which would produce capital gain,[47] while the buyer would resist, citing the nondepreciability of goodwill[48] and preferring, instead, an allocation to the seller's covenant not to compete, which is amortizable.[49] The cost to the seller, however, of giving that amortization benefit to the buyer, would be ordinary income.[50]

As indicated, when an agreement was challenged, it was

43. *See* Rothman, *Capital Assets—Sale of a Business or Property Used in a Trade or Business*, Tax Mgmt. (BNA) No. 447, at A-1 to A-2; Colson, *supra* note 36, at 302-04; Brown, *supra* note 36, at 2209.

44. *See infra* notes 51-52 and accompanying text.

45. *See infra* note 107.

46. Treas. Reg. § 1.167(a)-2 (1960).

47. *See, e.g.*, Michaels v. Commissioner, 12 T.C. 17 (1949), *acq.*, 1949-1 C.B. 3.

48. Treas. Reg. § 1.167(a)-3 (1960).

49. Assuming the covenant has a definite term, it would have an ascertainable useful life over which the cost allocated to it could be amortized. *See* Treas. Reg. § 1.167(a)-3 (1960).

50. *See, e.g.*, Sonnleitner v. Commissioner, 598 F.2d 464 (5th Cir. 1979).

usually challenged by way of one of the parties reporting a more favorable allocation for tax purposes. The IRS has generally insisted that the parties to an arm's length agreement adhere to the agreed allocations, and the courts have been reluctant to allow a party to ignore what was bargained for.

The Tax Court and several circuit courts of appeal require the challenging party to produce "strong proof" that the contract as written did not conform to the intent of the parties.[51] However, the more recent trend of decisions seems to be to require an even higher standard of proof, the so-called "Danielson rule." Under the Danielson rule the challenging party's burden is to produce "proof which in an action between the parties to the agreement would be admissible to alter the construction or to show its unenforceability because of mistake, undue influence, fraud or duress."[52]

The elimination of the preferential tax treatment for capital gains by the Tax Reform Act of 1986 has significantly reduced the seller's concern with whether gains are capital or ordinary while leaving the buyer's preferences largely intact.[53] These changes make it less likely that the seller and buyer will

51. *See, e.g.*, Harvey Radio Laboratories, Inc., 470 F.2d 118 (1st Cir. 1972); Ullmann v. Commissioner, 264 F.2d 305 (2d Cir. 1959); Peterson Machine Tool Inc. v. Commissioner, 79 T.C. 72, 81 (1982).

52. *See* Commissioner v. Danielson, 378 F.2d 771, 775 (3d Cir. 1967), *cert. denied*, 389 U.S. 858 (1967); Dakan v. United States, 492 F.2d 1192 (Ct. Cl. 1974). *Compare* Sonnlietner v. Commissioner, 598 F.2d 464 (5th Cir. 1979) ("strong proof" rule) *with* Spector v. Commissioner, 641 F.2d 376, 386 (former 5th Cir., 1981) (adopting "Danielson rule" for at least some purposes); *see also* Patterson v. Commissioner, 810 F.2d 562, 572 (6th Cir. 1987) (Sixth Circuit adopted "Danielson rule" after having at least impliedly endorsed the Tax Court's "strong proof" rule in Bennett v. Commissioner, 29 T.C.M. 1230 (1970), *aff'd per curiam*, 450 F.2d 959 (6th Cir. 1971)); Bradley v. United States, 730 F.2d 718, 720 (11th Cir. 1984) (successor to 5th Cir. adopts position of *Spector* for Eleventh Circuit); Schulz v. Commissioner, 294 F.2d 52, 55 (9th Cir. 1961) (Ninth Circuit had also applied the "strong proof" rule in this case but subsequently suggested that it might apply the stricter rule in Palo Alto Town & Country Village, Inc. v. Commissioner, 565 F.2d 1388, 1390 (9th Cir. 1977)).

53. One significant change from the buyer's standpoint was the repeal of the investment tax credit for purchases after 1985. Previously, most tangible depreciable properties other than buildings (but including single purpose agricultural or horticultural structures) would qualify for the credit. I.R.C. § 48(a) (1988). *See, e.g.*, Rev. Rul. 66-89, 1966-1 C.B. 7. However, even though no longer qualifying for the credit, the buyer would still generally favor an allocation of purchase price to such assets in order to facilitate tax recovery through depreciation.

have adverse tax interests as to specific allocations. Some differences remain, however.

3. Allocation in Absence of Agreement

If there were no agreed allocation among the various assets sold, or no agreement as to some of them, both seller and buyer would be tempted to report allocations that best served their respective tax interests. In this situation the government would find itself whipsawed between the two positions—losing revenues on both ends.[54]

In challenging an allocation to a particular asset, the IRS would in effect determine that the asset had a value different from that used by the buyer or seller in making the reported allocation, which in turn meant that the reported allocation was too high or too low (generally too high if by a seller with respect to property producing capital gains and by a purchaser with respect to depreciable property, and too low by a seller with respect to assets yielding ordinary income and by a buyer with respect to nondepreciable property or depreciable property with a long depreciation period). If litigated, the question was one of fact with the IRS's determination of value presumptively correct. The taxpayer had the burden of overcoming this presumption by clear and convincing evidence.[55] This was not an easy task.[56]

Most of the controversies were not in the farm context, but rather involved the sales of businesses with significant going concern value, with the primary dispute concerning the proper valuation of goodwill and similar nonamortizable intangibles.[57] Where there was no agreed allocation to these intangibles, one of two methods was generally utilized: (1) The

54. *See* S. REP. No. 313, 99th Cong., 2d Sess. 254 (1986) (concerning section 1060, subsequently enacted by TRA 1986: "In many instances the parties' allocations for tax reporting purposes are inconsistent, resulting in a whipsaw of the government.").

55. Tax Ct. R. Prac. & Proc. 142.

56. For a discussion of some of the mechanics and difficulties of proving value, see Colson, *supra* note 36 at 299-304. For examples of failures to meet the burden of proving a proper allocation in a farm context, see, *e.g.*, Parker Tree Farms, Inc. v. Commissioner, 46 T.C.M. (CCH) 493, 500 (1983), *aff'd without published opinion*, 813 F.2d 402 (4th Cir. 1986) (purchaser failed to sustain burden to overcome IRS's allocation of purchase price between depreciable and nondepreciable assets); Huber v. Commissioner, 49 T.C.M. (CCH) 57, 62 (1984).

57. *See* Rothman, *supra* note 43, at A-1 to A-2.

allocation was made by determining the fair market value of each asset and apportioning the consideration among the assets on the basis of their relative fair market values;[58] or, (2) the allocation was made by the so-called "residual method" under which the consideration was first allocated to cash and cash equivalents, then to other assets other than nonamortizable intangibles such as goodwill, with the remaining unallocated consideration, if any, being allocated to the nonamortizable intangibles.[59]

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58. *Id.* This type of allocation is required by the literal terms of the regulations with respect to the purchase of both depreciable and nondepreciable assets. Treas. Reg. § 1.167(a)-5 (as amended in 1986). For illustrative cases involving farm property, see, *e.g.*, Wolfsen Land & Cattle Co., 72 T.C. 1 (1979): "If the amount actually paid for the ranch and its component parts differs from the ranch's fair market value as of the sale date, then the basis allocation for depreciation purposes must be based on the relative actual fair market value of the ranch and its component parts." *Id.* at 18 (citing Treas. Reg. § 1.167(a)-5). To similar effect in a case involving allocation of a lump sum purchase price among depreciable and nondepreciable assets, see *Huber*, 49 T.C.M. (CCH) at 57. This method seems generally to have been used whenever nonamortizable intangibles were not a significant factor.

59. *See* Rothman, *supra* note 43, at A-2. The residual method was most often used when the assets sold consisted of a going business, and where nonamortizable intangibles such as goodwill could be expected to constitute a significant component of value. Since typical sales of farm properties did not involve significant going concern value, there would generally be no "residue" of sales price to allocate to nonamortizable intangibles. In this sense, therefore, this valuation technique differs little from simply determining the fair market value of the assets involved and apportioning the sales price among the assets based on the relative values.

However, Davis v Commissioner, 24 T.C.M. (CCH) 157 (1965) provides an interesting example in the farm context. The taxpayers purchased all the shares of a California farming corporation and immediately liquidated it by distributing its assets to themselves and assuming its liabilities. The assets received included a growing lemon crop, which the brothers had presold before acquisition of the shares. In accordance with applicable case law, the taxpayers allocated the purchase price of the shares among the assets received by them in the liquidating distribution. In determining the amount to be allocated to the growing lemon crop, the taxpayers used a residual method under which the purchase price was first allocated to cash and "cash equivalents," consisting of so-called "quick assets," with the remainder of the purchase price allocated to the other assets received. The taxpayers contended that the "quick assets," and thus the cash equivalents, included the lemon crop at the price at which it was sold under the preexisting contract. This would of course result in no gain on the sale. The IRS, on the other hand, contended that the value of the lemon crop as part of the acquired assets of the corporation was less than the contract price for the sale of the crop, that the crop was not a cash equivalent, and that its basis could not exceed its value at the time of acquisition as part of the corporation's assets. This approach would result in a gain on the sale of the crop. The Tax Court rejected the notion that the crop was a cash equivalent even though there was a preexisting contract of sale:

> In the instant case, accepting the proposition advanced by petitioners that in

The primary difficulty in these types of controversies—valuing goodwill and similar nonamortizable intangibles—was generally not a significant factor in farm sales transactions because these intangibles usually do not constitute a substantial component of value with respect to typical sales of farm property.[60]

4. Enactment of Section 1060

The residual approach to valuation was adopted by regulation under section 338 for purposes of valuing the assets of a corporation where a purchase of the stock of the corporation was treated as a purchase of the corporation's assets. Section 1060, enacted by the Tax Reform Act of 1986, codifies this approach with respect to "any applicable asset acquisition."[61]

The primary motivation for the enactment of this provision was the difficulty of establishing the value of goodwill and going concern value in controversies involving the proper allocation of consideration among the assets of a sold/purchased going business.[62] These controversies developed primarily in cases where the sales agreement did not allocate the sales price, or where an agreed allocation was made by parties not having adverse interests.[63]

> making the allocation of the composite price paid by petitioners for the Del Norte assets among the various assets acquired, the total price should be reduced by cash or its equivalent, we do not agree with petitioners that the lemon crop was the equivalent of cash to any greater extent than any of the other assets they acquired.

Id. at 165.

60. *See* Lemmen v. Commissioner, 77 T.C. 1326 (1981) (The IRS took the position that the amount of purchase price for cattle in excess of their fair market value represented a " 'premium' . . . similar in nature to the 'going concern value' of a 'business' which is not subject to depreciation'." The Tax Court disagreed, finding that the premium over fair market value represented amortizable maintenance contracts.).

61. *See* I.R.C. § 1060(a) (1988).

62. *See* S. REP. NO. 313, 99th Cong., 2d Sess. 253-54 (1986):

> Purchase price allocations have been an endless source of controversy between the Internal Revenue Service and taxpayers, principally because of the difficulty of establishing the value of goodwill and going concern value. The Service lacks the resources to challenge allocations to goodwill or going concern value in all or even a substantial portion of the cases in which it would otherwise assert that the value of those assets are misstated.

Id.

63. *Id.* at 251, 254.

5. What Section 1060 Requires

Section 1060(a) provides that, with respect to "any applicable asset acquisition," both the seller and the buyer will be required to allocate consideration among the assets as provided in section 338(b)(5). That latter provision merely gives the Treasury Department the authority to issue regulations prescribing such allocation, so the regulations tell the real story, and the story is about the use of the residual method.[64] Temporary regulations have also been issued under section 1060.[65] The allocation method prescribed therein is substantially the same as that under the section 338 regulations.[66]

If section 1060 applies, *both* the seller and buyer must use the prescribed allocation method.[67] This required allocation will thus establish the seller's gain or loss with respect to each asset sold and the buyer's basis in each asset acquired.[68] The "consideration" to be allocated is the seller's "amount realized" and the buyer's cost.[69] These may not be equal since, for example, the seller's amount realized may be reduced by selling expenses incurred by the seller, such as commissions, which would not reduce the buyer's costs.[70]

The temporary regulations provide that the consideration will be allocated according to a four part scheme.

(1) Consideration is first allocated to Class I assets, which include "cash, demand deposits and like accounts in banks, savings and loan associations (and other depositary institutions), and other similar items designated in the Internal Revenue Bulletin by the Internal Revenue Service."[71]

(2) Remaining unallocated consideration (after reduction for allocations to Class I assets) is next allocated among Class II assets, in a total amount equal to the aggregate value of Class II assets, "in proportion to the fair market values of

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64. *See* Temp. Treas. Reg. § 1.338(b)-2T (1986).

65. T. D. 8215, 1988-2 C.B. 304.

66. *Id.* at 309 (explanation of temporary regulations under section 1060).

67. I.R.C. § 1060(a) (1988).

68. *Id.*; Temp. Treas. Reg. § 1.1060-1T(a)(1) (1988).

69. Temp. Treas. Reg. § 1.1060-1T(c)(1) (1988). *See also supra* notes 17-26 and accompanying text (discussing what is included in the seller's "amount realized").

70. *See supra* notes 24-26 and accompanying text (discussing the impact of selling expenses on the seller's amount realized).

71. Temp. Reg. § 1.1060-1T(d)(1) (1988).

such Class II assets on the purchase date."[72] Class II assets consist of "certificates of deposit, U.S. government securities, readily marketable stock or securities . . . foreign currency, and other items designated in the Internal Revenue Bulletin by the Internal Revenue Service."[73]

(3) Remaining unallocated consideration (after reduction for allocations to Classes I and II) is allocated, in a total amount equal to the aggregate value of Class III assets, in proportion to the fair market value of Class III assets on the date of purchase.[74] Class III assets consist of all assets, both tangible and intangible, not assignable to Classes I, II, and IV.[75] Since Class IV assets consist of "intangible assets in the nature of goodwill and going concern value,"[76] Class III assets will contain the bulk of the assets of most businesses, including "furniture and fixtures, land, buildings, equipment, accounts receivable, and covenants not to compete."[77]

(4) The remaining unallocated consideration (after reduction for consideration allocated to Classes I, II, and III) is allocated to Class IV assets.[78]

The effect of this scheme is generally to allocate any "premium" paid for a business in excess of the apparent aggregate values of the identified assets to Class IV nonamortizable intangibles.[79] Thus, even if the sales agreement provides for a specific assignment of value to goodwill or similar Class IV intangibles, if the aggregate apparent value of all assets including the identified goodwill is less than the consideration paid, the excess "premium" serves to augment only the Class IV allocation and cannot be used to augment the allocations to other classes.[80] Put differently, any excess premium over the aggregate apparent values of the identified assets other than Class IV assets is allocated to Class IV. This residual alloca-

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72. Temp. Reg. § 1.1060-1T(d)(2) (1988).
73. Temp. Reg. § 1.1060-1T(d)(2)(i) (1988).
74. Temp. Reg. § 1.1060-1T(d)(2) (1988).
75. Temp. Reg. § 1.1060-1T(d)(2)(ii) (1988).
76. Temp. Reg. § 1.1060-1T(d)(2)(iii) (1988).
77. Temp. Reg. § 1.1060-1T(d)(2)(ii) (1988).
78. Temp. Reg. § 1.1060-1T(d)(2) (1988).
79. *See* GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 357-58 (1986) (prepared by the Staff of the Joint Committee on Taxation).
80. *Id.*

tion to Class IV would be of primary concern to the buyer, because of the nonamortizability of Class IV costs, since any gain with respect to Class IV assets would generally be capital gain from the seller's standpoint.

The allocations to a particular asset in any class except Class IV cannot exceed the fair market value of that asset on the date of purchase.[81] Since Class I consists essentially of cash and cash equivalents, Class II consists of assets which will generally be readily valuable, and Class IV is allocated all residual unallocated value, the primary fair market value determinations will likely be with respect to Class III assets.

The fair market value of a particular asset is generally "its gross fair market value (i.e., fair market value determined without regard to mortgages, liens, pledges, or other liabilities)."[82] However, the amount allocated to a particular asset which is subject to a nonrecourse indebtedness will be at least equal to that indebtedness for purposes of determining the seller's gain or loss with respect to such asset.[83]

6. "Applicable Asset Acquisition"

The required allocation regime of section 1060 applies to "any applicable asset acquisition."[84] An "applicable asset acquisition" is defined to mean "any transfer (whether directly or indirectly) . . . (1) of assets which constitute a trade or business, and (2) with respect to which the transferee's basis in such assets is determined wholly by reference to the consideration paid for such assets."[85] A straight sale and purchase of a "trade or business" would thus qualify, because basis would be determined "wholly by reference to the consideration paid for such assets."[86] However, an "applicable asset acquisition" can also include a transaction which qualifies in part as a tax-free exchange of like-kind property under section 1031, even though the bases of the assets involved in such an exchange

81. Temp. Treas. Reg. § 1.1060-1T(e)(1) (1988).

82. Temp. Treas. Reg. § 1.1060-1T(c)(2) (1988).

83. *Id.* This is apparently required by section 7701(g), which codifies the *Tufts* rule. *See supra* note 23 and accompanying text.

84. I.R.C. § 1060(a) (1988).

85. I.R.C. § 1060(c) (1988).

86. *See* I.R.C. § 1012 (1988); Treas. Reg. § 1.1012-1(a) (as amended in 1980).

are not determined "wholly by reference to the consideration paid for such assets."[87]

The most difficult issue as to the applicability of section 1060 will be whether the assets transferred constitute a "trade or business." A group of assets will constitute a trade or business if it would constitute an "active business" for purposes of section 355 (relating to distributions by a controlling corporation to its shareholders or security holders of stock or securities of a controlled corporation).[88] However, a group of assets may qualify as a trade or business for section 1060 purposes even if it is not an active business for section 355 purposes.[89]

Since the primary result of the required allocation regime is to assign any premium over the aggregate apparent fair market values of identified assets to Class IV goodwill and similar nonamortizable intangibles, it is not surprising that a "trade or business" for section 1060 purposes includes any group of assets "if its character is such that goodwill or going concern value could under any circumstances attach to such group."[90] The group of assets will be considered a trade or business for this purpose if it constitutes a trade or business in the hands of *either* the seller or buyer.[91]

7. Reporting Requirements Under Section 1060

When the transaction constitutes an "applicable asset acquisition," both the buyer and seller must report information concerning the amount of consideration and its allocation among the assets transferred.[92] The temporary regulations require that the seller and buyer must *each* file Form 8594 with their returns for the year of the transaction.[93]

The current Form 8594 generally requires reporting of only the aggregate values allocated to each class of assets, and

87. I.R.C. § 1060(c) (1988).

88. Temp. Treas. Reg. § 1.1060-1T(b)(2) (1988).

89. *Id.*

90. Temp. Treas. Reg. § 1.1060-1T(b)(2) (1988).

91. Temp. Treas. Reg. § 1.1060-1T(b)(1) (1988).

92. I.R.C. section 1060(b)(1) literally requires only the reporting of the amount of the consideration allocated to goodwill or going concern value. However, the temporary regulations require reporting as to total consideration and its allocation among all the assets. Temp. Treas. Reg. § 1.1060-1T(h)(1) (1988).

93. Temp. Treas. Reg. § 1.1060-1T(h)(2)(i) (1988).

does not require a break down on allocations of value within each class. An exception is with respect to Class III intangible amortizable assets since the form requires separate reporting of value allocated to each such asset.

Commentators have criticized this current version of Form 8594 because it does not require reporting of allocations within the classes. This facilitates inconsistent allocations by the seller and buyer within classes, particularly Class III assets other than intangible amortizable assets.[94]

8. Impact of Section 1060 on Farm Sales

In many straight sales and purchases of farm property, there will likely be a substantial question as to whether the transaction constitutes an applicable asset acquisition within the meaning of section 1060. A sale of a group of assets will qualify if the group of assets constitutes a trade or business in the hands of either the seller or buyer.[95] A sale by a farmer in one transaction to one purchaser of all or substantially all of the assets of the seller's farming operation would certainly seem to qualify as the sale of a trade or business even if goodwill or going concern value is not a significant component of value with respect to the assets sold. Section 1060 may also impose some reporting and allocation requirements with respect to the sale by a partner of a partnership interest in a farming partnership.[96]

On the other hand, would the sale, for example, of a particular parcel of farm land qualify if the seller continues to farm with respect to remaining assets? It seems likely that it would not.[97] It is possible, however, that a purchaser from a

94. *See* Olchyk & Elliott, *supra* note 35, at 372-75.

95. Temp. Treas. Reg. § 1.1060-1T(b)(1) (1988).

96. The Technical and Miscellaneous Revenue Act of 1988 added I.R.C. section 1060(d), which may impose some reporting and allocation requirements both with respect to sales of partnership interests and distributions by a partnership of partnership assets. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1006(h), 102 Stat. 3342 (1988) [hereinafter TAMRA 1988].

97. *See* Olchyk & Elliott, *supra* note 35, at 375, who point out that the temporary regulations make continual reference to a "group of assets" and do not refer to a sale of a *single* asset. They indicate that "the spirit of Section 1060 appears to be directed toward the sale of assets constituting an ongoing business as a layman would think of a business." *See also* Priv. Ltr. Rul. 9001013 (Jan. 5, 1990). The ruling dealt with a proposed sale by a corporation engaged in grain farming of 140 acres of farm land to a

single seller may buy enough land and equipment to set up a farming operation which constitutes a trade or business from the buyer's standpoint even though the seller continues farming operations with remaining assets. This raises the question of whether a seller who is not disposing of his entire farming operation must determine whether the group of assets sold will constitute a trade or business in the hands of the buyer. It would seem that this is necessary since both buyer and seller must file Form 8594 if the assets constitute a trade or business as to *either* the seller or buyer.[98] Moreover, the buyer cannot allocate more consideration to depreciable assets purchased in an applicable asset acquisition than allowed under section 1060.[99]

The reporting requirements under section 1060 may actually have a salutary impact with respect to many farm sales which are or may be applicable asset acquisitions. The requirement under the temporary regulations that prices be allocated among the various classes of property for reporting purposes should encourage the parties to arrive at such class allocations by mutual agreement in order to avoid inconsistent reporting. Having gone that far, they may be inclined to agree to mutually acceptable allocations among assets within particular classes, although such allocations need not be reflected on the current Form 8594.

It is clear that allocation agreements between the parties to an applicable asset acquisition are contemplated. The current Form 8594 specifically asks whether the buyer and seller provided "for an allocation of the sales price in the sales contract or in another written document signed by both parties?"[100] The very next question is then whether the allocated values to Classes I, II, and III are consistent with the agreed allocations.

It is also clear that an agreed allocation can be ignored by

shareholder in the corporation. This land did not constitute all the assets of the corporation's farming operation. The ruling concluded that "it does not appear that the proposed sale represents a disposition of the entire assets that constitute the trade or business of the corporation as contemplated by section 1060(c)(1) of the Code."

98. Temp. Treas. Reg. § 1.1060-1T(b)(1), (h)(2)(i) (1988).

99. Temp. Treas. Reg. § 1.167(a)-5T (1988).

100. Part II, #2 of July 1988 edition of the form.

the IRS.[101] When is the IRS likely to accept an agreed allocation among classes of assets and among assets within a particular class with respect to an applicable asset acquisition? It seems probable that such agreements will generally be given the same respect as such agreements were given before the enactment of section 1060. That is, arm's length allocations by parties having inconsistent tax interests will likely be accepted.[102]

Since it is unlikely that a typical farm sale will carry a sales price with a significant "premium" over the apparent aggregate value of identified assets, there would generally not be the potential for a substantial underreporting of allocations to Class IV nonamortizable intangibles, which is a primary concern of section 1060. It would thus seem that the seller and buyer in a typical farm sales transaction would generally have the same incentives to arrive at mutually agreed allocations as they have always had, and would, where section 1060 applies or may apply, now have the additional incentive of facilitating compliance with the section 1060 reporting requirements.

As a practical matter, however, almost all assets in the typical sale of farm property would properly be allocated to Class III, including assets such as land, buildings, equipment, and livestock.[103] Any agreement as to allocation in this situation would therefore primarily concern itself with allocations within that class.

9. Agreed Allocations Among Farm Assets

Assuming an arm's length allocation between parties having adverse tax interests will generally continue to be

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101. Temp. Treas. Reg. § 1.1060-1T(g) (1988) (Example (4)) (It illustrates an agreed allocation of value to a covenant not to compete. The example indicates that "the District Director, in determining the fair market values of the assets transferred, may disregard the parties' agreement.").

102. *See supra* notes 42-53 and accompanying text. *See also* GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 359 (1986).

> In requiring use of the residual method, the Congress did not intend to restrict in any way the ability of the Internal Revenue Service to challenge the taxpayer's determination of the fair market value of any asset by any appropriate method and to take into account all factors, including any lack of adverse tax interests between the parties.

Id.

103. *See* Temp. Treas. Reg. § 1.1060-1T(d)(2)(ii) (1988).

respected by the IRS, two initial questions arise: (1) To what extent would the parties to a typical farm sale and purchase transaction have adverse interests? (2) How can agreements as to specific allocations be facilitated?

If a sale involves farm properties falling into multiple tax types, the tax interests of the buyer and seller may be adverse as to some assets but not as to others. The IRS could challenge an agreed allocation to a particular asset while not challenging allocations to other assets.[104] On the other hand, if the parties have some substantial adverse tax interests, those adverse interests may be reflected in compromises made not only as to allocations with respect to particular assets where the tax interests are clearly adverse, but also with respect to allocations to nonadverse assets, since every allocation in a multiple asset sale affects the amount of consideration which can be allocated to other assets. A consideration of the extent to which the interests of the buyer and seller in a farm sale are adverse, and thus entitled to respect, should arguably not be simply limited to an asset-by-asset determination of the competing interests.

VI. OPPOSING INTEREST FOR SPECIFIC ALLOCATIONS

What follows is a discussion of some of the likely opposing tax interests of the seller and buyer with respect to particular assets. Not all assets that may be involved in a farm sale are specifically addressed, but those chosen are probably representative of the types of allocation issues which may arise.

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104. *See, e.g.*, Temp. Treas. Reg. § 1.1060-1T(g) (1988) (Example (4)) (agreed allocation to covenant not to compete disregarded in the example). *See also* Lemmen v. Commissioner, 77 T.C. 1326 (1981):

> In terms of the total consideration passing between petitioner and CCR as a result of the herd-purchase and maintenance agreements, petitioner's dealings with CCR were clearly carried on at "arm's length." We have no doubt petitioner and CCR were, in general, "economically self-interested." Nonetheless, we think that this was not the case with respect to the establishment of a purchase price for the cattle independent of the maintenance contract offered to a herd purchaser.

Id. at 1348. The court went on to characterize part of the price of the cattle as for a separate maintenance contract.

A. Seller's Preferred Allocations—General

As previously indicated,[105] to the extent the seller expects to realize gain with respect to particular assets, the tax goals will generally be: (1) Maximizing the amount of gains which will qualify for nonrecognition;[106] and, (2) as to gains which must be recognized, maximizing the amount of gains which will qualify as capital gains.[107]

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105. *See supra* Section III. B.1.

106. Gains or losses *realized* will generally be *recognized* (i.e., gain will be reported into income and losses will be deducted) during the taxable year in which realized except to the extent the Code otherwise provides. I.R.C. § 1001(c) (1988); Treas. Reg. § 1.1002-1(a) (1960). The most important nonrecognition provisions in the context of typical farm real estate sales and exchanges are probably:

> (1) Section 1034, which provides for nonrecognition of gain realized on the sale of a taxpayer's principal residence where a replacement residence is acquired within specified time limitations.
>
> (2) Section 121, which provides for a one-time exclusion of gain realized up to $125,000 ($62,500 in the case of a married individual filing separately) on the sale of a principal residence by a taxpayer who is at least 55 years of age and meets specified holding period requirements with respect to the residence. No replacement property need be acquired to qualify for nonrecognition of gain under section 121.
>
> (3) Section 1041, which provides that no gain or loss will be recognized on transfers between spouses or between former spouses if the transfer is "incident to divorce."
>
> (4) Section 1031, which provides for nonrecognition of gain or loss on exchanges of properties held for productive use in a trade or business or for investment.
>
> (5) Section 1033, which generally provides for nonrecognition of gain realized on a compulsory or involuntary conversion of property where qualifying replacement property is acquired within specified time limitations.

Sections 121 and 1034, dealing with the principal residence of the seller, and section 1031 dealing with exchanges of property, are the nonrecognition provisions most likely to be at issue in typical farm transfer transactions.

107. Prior to the Tax Reform Act of 1986, as a general rule, a seller who expected to recognize gains on a sale would want those gains classified in the following order of preference, with the first being most desirable: (1) Long-term capital gains, (2) short-term capital gains, and (3) ordinary income. The seller thus usually wanted to maximize long-term capital gains while minimizing ordinary income.

Capital gains were preferred over ordinary gains because of the possible preferential tax treatment of the former. A taxpayer other than a regular corporation could claim a deduction equal to 60% of such taxpayer's "net capital gains" for a particular taxable year. I.R.C. § 1202(a), before change by TRA 1986. This meant that only 40% of the net capital gain would be taxed in the regular manner. Since the maximum marginal tax rate for individuals was 50% (I.R.C. § 1, before change by TRA 1986), the maximum effective tax rate with respect to the entire net capital gain was only 20% (50% x 40% of net capital gain).

If a regular corporation had net capital gain during a particular year, the corporation would pay the regular tax which resulted from including the net capital gain in its

To the extent losses are expected with respect to particu-

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income or, if lesser in amount, a tax on its taxable income computed by excluding the net capital gain, plus a tax of 28% on the net capital gain. I.R.C. § 1201(a), before amendment by TRA 1986. This effectively limited the maximum tax rate on corporate net capital gain to 28%.

"Net capital gains" are computed by a netting process:

> (1) Long-term capital gains and losses are netted to produce either net long-term capital gain or net long-term capital loss. I.R.C. § 1222(7)-(8) (1988).
>
> (2) Short-term capital gains and losses are netted to produce either net short-term capital gain or net short-term capital loss. I.R.C. § 1222(5)-(6) (1988).
>
> (3) Net long-term capital gain, if any, is netted with net short-term capital loss, if any. If the net is a gain, it will be a "net capital gain" qualifying for the preferential tax treatment. I.R.C. § 1222(11) (1988).

The key ingredient in producing a net capital gain is thus "long-term capital gain." *See* I.R.C. § 1222 (1988). Long-term capital gains were thus generally preferred over either short-term capital gains or ordinary gains.

The Tax Reform Act of 1986 phased in an elimination of the preferential tax treatment given to long-term capital gains. The special deduction for net capital gains for taxpayers other than corporations was eliminated. The special cap on the maximum rate a corporation would pay with respect to net capital gains was also removed.

While the maximum tax rate on ordinary income with respect to taxpayers other than corporations was brought down from 50% to 33% (*see* I.R.C. § 1 as amended), the maximum rate with respect to net capital gains increased from 20% to 33%. If a seller now has only gains during a particular year, those gains will be taxed in the same manner whether capital or ordinary. On the other hand, if the seller also has some capital losses during the year, capital gains can serve to increase the deductible capital losses, and would thus be desirable for that reason. *See infra* notes 108-09 and accompanying text. Since both long- and short-term capital gains would serve this purpose equally well, there would generally be no reason to prefer one over the other.

It is very possible, however, that the distinction between capital gains and ordinary income will soon become more relevant again. Under President Bush's 1991 budget proposals, an exclusion of 30% would be provided to individuals who realize gains with respect to qualified assets held for at least three years. An exclusion of 20% would be available for qualifying assets held for more than two but less than three years. Qualified assets held for at least one year but less than two would be eligible for an exclusion of 10%. Assets qualifying for these exclusions would generally be the same assets that qualify for capital gains treatment under current law.

There are two main statutory avenues to capital gains and losses, sections 1221 and 1231. Section 1221 defines "capital assets" in an exclusionary manner. Capital assets are said to include all properties other than those specifically excluded in section 1221(1)-(5).

The most important exclusions in the farm context are those in section 1221(1) and (2). Section 1221(1) excludes stock in trade or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. This exclusion would generally cover much of farm livestock and crops.

Section 1222(2) excludes property used in the taxpayer's trade or business of a character subject to the allowance for depreciation, and real property used in the taxlar assets, the seller's goals will generally include: (1) Maximizing recognition of losses;[108] and, (2) maximizing the

payer's trade or business. This exclusion will generally cover farm land, depreciable improvements to the land, machinery, equipment, and livestock not excluded by section 1221(1).

Most farm property will qualify for capital gain or loss treatment, if at all, under section 1231. Section 1231(a) generally provides that if the gains on the sale of property described in section 1231(b) ("section 1231 property") for the particular taxable year exceed the losses on the sale of such property for the same year, they will be treated as long-term capital gains and losses. On the other hand, if the losses exceed the gains, both gains and losses will be ordinary. Section 1231 can thus give the "best of both worlds" in that when covered gains exceed losses, the traditionally favored long-term capital gain treatment will apply to the excess, and when losses exceed gains, the favored ordinary loss treatment will apply to the excess.

The properties described in section 1231(b) include the following:

(1) Depreciable property used in the trade or business and held for more than one year. I.R.C. § 1231(b)(1) (1988). This would include, assuming the minimum holding period requirement is satisfied, machinery, equipment, and depreciable improvements on farm land.

(2) Real property used in the trade or business and held for more than one year. *Id.* This would include the farm land itself.

(3) Cattle and horses held for draft, breeding, dairy, or sporting purposes and held by the taxpayer for at least twenty-four months from the date of acquisition. I.R.C. § 1231(b)(3)(A) (1988).

(4) Other livestock, excluding poultry, held for draft, breeding, dairy, or sporting purposes and held by the taxpayer for at least twelve months from the date of acquisition. I.R.C. § 1231(b)(3)(A) (1988). The term "livestock" for this purpose includes hogs, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals, but excludes poultry, chickens, turkeys, pigeons, geese, other birds, fish, frogs, and reptiles. Treas. Reg. § 1.1231-2(a)(3) (as amended in 1982).

(5) Unharvested crops if the land and crops are sold, exchanged, or compulsorily or involuntarily converted at the same time to the same person and the land itself qualifies as section 1231 property. I.R.C. § 1231(b)(4) (1988). However, section 1231 does not apply to the disposition of unharvested crops if the taxpayer retains any right or option to reacquire, directly or indirectly, the land the crop is on, "other than a right customarily incident to a mortgage or other security transaction." Treas. Reg. § 1.1231-1(f) (as amended in 1982). If the unharvested crop qualifies as section 1231 property, no deduction (whether for the current or some other taxable year(s)) attributable to the production of the crop is allowable. I.R.C. § 268 (1988). This disallowance provision applies to all items attributable to the production of the crop, including depreciation, and applies even though the gain realized is not recognized. Beauchamp & Brown Groves v. Commissioner, 371 F.2d 942 (9th Cir. 1967), *aff'g* 44 T.C. 117. The amount of any deductions disallowed in this manner is added to the disposing taxpayer's basis in the unharvested crop. I.R.C. § 1016(a)(11) (1988); Treas. Reg. § 1.1016-5(g) (as amended in 1987).

108. Several provisions may limit the recognition of transactional losses. Sections 165(c) and 262 in tandem limit the deduction for losses realized by individuals to those losses incurred in a trade or business or in a transaction entered into for profit, or with respect to specified casualties (with the casualty loss deduction being further severely

amount of recognizable losses which will be reportable as ordinary losses.[109]

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restricted by section 165(h)). The result is that losses realized on the sale of assets used for personal purposes, such as a personal residence, will generally not be deductible. Treas. Reg. § 1.165-9(a) (as amended in 1964); Treas. Reg. § 1.262-1(b)(4) (as amended in 1972). Sections 165(f), 1211, and 1212 limit the amount of capital losses (otherwise deductible under section 165) which can be deducted in any particular taxable year.

Section 267 disallows the deduction for losses resulting from the sale or exchange of property between specified related parties. Section 707(b) provides similarly with respect to losses resulting from sales or exchanges of property between partners and controlled partnerships or between two controlled partnerships. On the other hand, gain on a subsequent sale by that related purchaser can be reduced by the amount of the disallowed loss. I.R.C. § 267(d) (1988).

Section 351 describes circumstances under which no gain or loss will be recognized by shareholders on the transfer of property by them to their controlled corporation in exchange for stock in that corporation. Similarly, section 721 generally provides for nonrecognition of gains or losses realized on transfers of property to a partnership in exchange for an interest in such partnership.

Section 1031 provides that no gain or loss will be recognized with respect to certain exchanges of "like kind" properties. Section 1041 provides for nonrecognition of losses on transfers between spouses and certain former spouses.

109. Note that a loss on the disposition of a passive activity may be increased (or a gain reduced) by previous "passive activity losses" disallowed by section 469(a). *See* I.R.C. § 469(g) (1988).

Prior to the Tax Reform Act of 1986, the seller would usually have the following preferences as to losses, in the priorities listed: (1) Ordinary losses; (2) short-term capital losses; and, (3) long-term capital losses. The seller would thus usually want to maximize ordinary losses while minimizing long-term capital losses. As a result of the changes made by TRA 1986, short- and long-term capital losses would generally be treated alike.

Although the preferential tax treatment for capital gains was eliminated by TRA 1986, the general limits on the deductibility of capital losses were retained. Losses are deductible only to the extent provided in section 165. However, section 165(f) provides that otherwise deductible capital losses will be deductible only to the extent provided in sections 1211 and 1212. Otherwise deductible ordinary losses are not subject to the limitations in these last two sections, which explains the general preference for ordinary losses over capital losses.

In the case of a taxpayer other than a regular corporation, the limitations on the deductibility of capital losses can generally be described as follows:

> (1) Capital losses for a particular taxable year can be deducted to the extent of capital gains for that year. I.R.C. § 1211(b)(1) (1988). This limitation will generally involve the following "netting" process: (a) Short-term capital gains and losses are netted; (b) long-term capital gains and losses are netted; (c) any net short-term or net long-term losses will be netted against any net short-term or net long-term gains.
>
> (2) If, after the netting process described above, there remain net capital losses, a *maximum* additional deduction of only $3,000 is allowed for such excess for that particular taxable year. *See* I.R.C. § 1211(b)(1) (1988).
>
> (3) Excess losses not deducted in a particular year because of the limitation described in (2) above, can be carried forward to succeeding years, be-

B. Buyer's Preferred Allocations—General

The general tax goals of the purchaser have also already been discussed.[110] In short, the buyer will generally want the purchase consideration allocated in such a way as to expedite the tax "recovery" of the buyer's costs.

C. Seller's Residence

1. The Seller

If the farm property being sold includes the seller's personal residence, the seller may prefer an allocation of consideration to the residence for two reasons *if* a gain will result: (1) The gain may qualify for nonrecognition under section 1034 or section 121; and/or (2) any gain recognized will generally constitute capital gain.[111] The seller should determine whether either or both of the two nonrecognition provisions may be applicable.[112]

What constitutes the "residence" for purposes of these nonrecognition provisions? It is not limited to the actual "house" itself, but can include surrounding property which was considered as part of the residential property, used as

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coming subject to the same limitations in each subsequent year as though they were incurred in that year. *See* I.R.C. § 1212(b)(1) (1988).

A regular corporation can deduct its capital losses only to the extent they do not exceed its capital gains for the same taxable year. I.R.C. § 1211(a) (1988). Any excess losses can generally be carried back to the three preceding taxable years and carried forward to the succeeding five taxable years. I.R.C. § 1212(a) (1988).

With respect to both corporate and noncorporate taxpayers, the limits on the deductibility of capital losses under § 1211 do not apply to the extent the taxpayer has offsetting capital gains in the same year. Thus, even though capital gains are not currently preferentially taxed, they will "soak up" capital losses in a way that ordinary income will not, and will be preferred to ordinary income by a seller who expects to have capital losses for the same year.

110. *See supra* Section IV.

111. A house used as the seller's personal residence and not for business purposes should qualify as a capital asset under section 1221. However, if a portion of the residence has been used for business purposes, and depreciation were allowable with respect to that part of the residence, there may be some "recapture" of ordinary income under section 1250. *See infra* note 124.

112. Under section 1034 gain on the sale of the old personal residence will qualify for nonrecognition only to the extent a new personal residence costing as must as the "adjusted sales price" of the old residence is purchased and occupied within two years of the sale of the old. I.R.C. § 1034(a) (1988). *See* Bayley v. Commissioner, 35 T.C. 288, 295 (1960) (new residence must be purchased and *physically occupied* by the new owners as a residence within the applicable time period).

such, and not used for business purposes.[113]

It should be noted that gain not recognized by reason of section 1034 is generally only deferred until a later date. The seller's basis in the new residence will be adjusted to build in potential gain equal to that realized but not recognized on the sale by reason of section 1034.[114] On the other hand, section 121 provides for a permanent nonrecognition of gain since the seller need not purchase another residence to qualify.

If the seller has a high basis in the personal residence such that any reasonable allocation is likely to result in a loss, the seller's interests will differ. A loss on the sale of the personal residence will not be deductible.[115] In that event, the seller would prefer to avoid realizing the loss in the first place. One case suggests a way to accomplish this. In *Cochran v. Commissioner*,[116] the taxpayers sold farm property, including their personal residence, to their wholly-owned corporation for a lump sum price equal to their aggregate bases in the property. The IRS made a separate allocation to the residence, resulting in a nondeductible loss. The Tax Court rejected the allocation on the grounds that the sale constituted "but a single sale for a single price and not a separate sale of the residence and another sale of the remaining portions of the property."[117]

The holding of this case seems clearly inconsistent with the rule that gain or loss is to be determined on an asset-by-asset basis.[118] In addition, the Tax Court has rejected an at-

113. For a good discussion of what constitutes the "residence" in the context of farm property, see Colson, *supra* note 36, at 305-12. For example, in one case, the seller's residence was determined to include 5.1 acres, including outbuildings, of the 183-acre farm, and the determination of the proper amount of consideration allocated to the residence was largely based on the allocation made in the sales agreement. Campbell v. Commissioner, 23 T.C.M. (CCH) 508 (1964). In another case, one and a half acres was found to be the residential property while the other six acres, which was being farmed, was excluded. Lokan v. Commissioner, 39 T.C.M. (CCH) 168 (1979). Another court found that one-third of the "ranch" was used for business purposes and was thus not part of the residential property for nonrecognition purposes. Reid v. United States, 24 A.F.T.R.2d (P-H) 69-5230 (D.C. Cal. 1969).

114. *See* I.R.C. 1034(e) (1988).

115. Treas. Reg. § 1.165-9(a) (as amended in 1964); Treas. Reg. § 1.262-1(b)(4) (as amended in 1972).

116. 18 T.C.M. (CCH) 985 (1959)

117. *Id.*

118. *See supra* notes 3-6 and accompanying text.

tempt by the IRS to treat parcels of land separately purchased and sold together as the sale of a single asset so as to preclude a separate loss with respect to one of the assets.[119]

Assuming a separate allocation is to be made to the seller's residence where a loss will result, the seller would prefer to minimize the nondeductible loss. Allocating more, rather than less, consideration to the residence would tend to accomplish this goal. Moreover, broadening or narrowing what is identified in the specific allocation as the seller's "residence" may reduce the nondeductible loss realized with respect to that asset.

2. The Buyer

The buyer's tax interests with respect to an allocation to the residence will likely oppose those of the seller to a greater or lesser degree depending on the use the buyer will make of the dwelling. If the buyer will use the dwelling as the buyer's personal residence, the buyer's only incentive to prefer allocation of purchase price to the dwelling will likely be where the buyer has gain from the sale of another personal residence which the buyer wishes to "roll over" into the seller's residence. This incentive would extend only to an amount necessary to accomplish nonrecognition with respect to the buyer's old residence.[120] Any additional allocation to the residence would be opposed by the buyer because the residence will not be depreciable,[121] and tax recovery with respect to it will be postponed until the house is sold or converted to a business use.

On the other hand, if the buyer intends to put the dwelling to a business use, such as by using it to house an employee, the cost allocated to the dwelling itself may be depreciable.[122] The buyer would prefer more allocation to this and other de-

119. *See* Davock v. Commissioner, 20 T.C. 1075 (1953).

120. Under section 1034, to effect complete nonrecognition with respect to a prior sale of buyer's old personal residence, the buyer's cost in seller's personal residence would have to at least equal the "adjusted sales price" of buyer's old residence. I.R.C. § 1034(a) (1988).

121. Treas. Reg. § 1.167(a)-2 (1960).

122. *See, e.g.*, Harrison v. Commissioner, 41 T.C.M. (CCH) 1384 (1981) as to the deductibility by an employer of the costs of furnishing "lodging" to an employee for the "convenience of the employer" within the meaning of section 11.

preciable assets as opposed to nondepreciable assets, such as the land on which the house sits. However, the buyer would naturally prefer that as much consideration as possible be allocated to other depreciable assets with shorter recovery lives.

D. Other Dwellings

The interests of the buyer and seller with respect to other dwellings on the property are more likely to be somewhat consistent. If a dwelling will be utilized to house employees for the "convenience of the employer" within the meaning of section 119, it may be depreciable by the purchaser, arguably over a twenty-year recovery period.[123] On the other hand, any gain realized on the dwellings will probably be treated as capital gains to the seller, except to the extent of any ordinary income "recapture" under section 1250.[124] Any "recapture"

123. The dwelling would arguably have a recovery of twenty years because that is the recovery period assigned to most "farm buildings" under the Modified Accelerated Cost Recovery System of section 168. *See* Rev. Proc. 87-56, 1987-2 C.B. 674 (Asset class 01.3). Twenty-year property is entitled to use an accelerated depreciation rate equal to 150% of the straight line rate, switching over to the straight line rate during the year for which that would yield a larger deduction. *See* I.R.C. 168(b)(2)(A), (b)(1)(B) (1988). This assumes that the dwelling is not rented to the employee or someone else, in which case it would presumably be residential rental property and assigned a recovery period of twenty-seven and a half years at a straight line rate. I.R.C. § 168(b)(3)(B), (c)(1) (1988). On the other hand, it is also arguable that the employee-used house would be nonresidential real property and assigned a recovery period of thirty-one and a half years. I.R.C. § 168(c)(1) (1988). Such property includes section 1250 property which is not residential rental property or property with a class life of less than twenty-seven and a half years. I.R.C. § 168(e)(2)(B) (1988). The employee-used house could qualify if not a "farm building" since it would not otherwise be assigned a class life of less than twenty-seven and a half years. This would seem an unfortunate result.

124. If a dwelling has been used to house employees for the convenience of the employer, it should constitute "real property used in the trade or business" within section 1231 if held for more than one year, and may qualify for capital gains under that provision. *See supra* note 107 and accompanying text.

Sections 1245 and 1250 may require that gains otherwise capital in nature be reported, in whole or in part, as ordinary income where the basis of the particular property being sold reflects adjustments for depreciation and other deductions. These provisions do not apply to losses. Treas. Reg. § 1.1245-1; § 1.1250-1(a)(5)(i) (as amended in 1972). These two sections will usually be the most important "recapture" provisions to apply to a typical farm sale.

Section 1250 is generally applicable to farm buildings and structural components which are not "section 1245 property" and thus governed by section 1250. Since section 1245 property includes "a single purpose agricultural or horticultural structure," amount would not qualify for installment reporting.[125]

E. Barns

The interests of both the buyer and seller with respect to barns will probably be similar to their interests with respect to dwellings used to house employees. That is, the seller will generally be entitled to report any gain as capital, subject to possible recapture under section 1250, and the buyer will be able to depreciate the cost allocated to it over twenty years.[126] Any ordinary income recapture would not qualify for installment reporting.

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section 1245, rather than section 1250, would be the governing provision as to that type of structure. *See* I.R.C. § 1245(a)(3)(D) (1988); I.R.C. § 1250(c) (1988).

Generally, under section 1250, if the covered building has been held for one year or less at the time of sale, an amount equal to the lesser of the gain realized or the total of the deduction adjustments reflected in the seller's basis must be reported as ordinary income. I.R.C. § 1250(a)(1), (b)(1) (1988).

If the section 1250 property has been held for more than one year, there will generally be no ordinary income recapture unless the seller's basis reflects adjustments for accelerated depreciation for some period after 1969. Treas. Reg. § 1.1250-1(a)(5)(ii), (b)(5)(ii) (as amended in 1972). The ordinary income recapture is limited to the amount by which the total of the depreciation adjustments reflected in the seller's basis exceeds the total of the adjustments which would be reflected in that basis if only straight line depreciation had been utilized with respect to the property. I.R.C. § 1250(a) (1988). In other words, there will be no recapture if (1) straight line, rather than an accelerated, depreciation had been used by the seller, or (2) if the property has been completely depreciated, since the total basis adjustments would then be equal whether straight line or accelerated depreciation were used.

The amount of recapture under section 1250 must generally be determined separately with respect to each section 1250 property. Treas. Reg. § 1.1250-1(a)(1) (as amended in 1972); *but see* Treas. Reg. § 1.1250-1(a)(2)(ii) (as amended in 1972). The regulations provide that where multiple properties are sold in one transaction, the total amount realized must be allocated among the various properties in proportion to relative fair market values. Treas. Reg. § 1.1250-1(a)(6) (as amended in 1972). An arm's length allocation agreement between a buyer and seller having adverse interests as to the allocation will usually be respected. *Id.* If the transaction constitutes an applicable asset acquisition under section 1060, the allocation procedures under the temporary regulations with respect to that provision should control. However, since the recapture assets would generally all be Class III assets and allocations within a class are to be on the basis of relative fair market values, the arm's length agreement as to allocations within that class should still generally control.

For a more in-depth discussion of section 1250 recapture in the context of farm properties, *see* J. O'BYRNE & C. DAVENPORT, FARM INCOME TAX MANUAL 667-74 (1989).

125. I.R.C. § 453(i) (1988).

126. *See supra* note 123.

F. Farm Machinery and Equipment

Farm machinery and equipment will generally constitute "section 1245 property" with respect to the seller.[127] As such, gain will generally be characterized as ordinary income to the full extent of depreciation adjustments reflected in the seller's adjusted bases in such property.[128] This may not be particularly important to the seller as long as ordinary income and capital gain are taxed at the same rates. However, if the seller has capital losses for the year, the deduction for those losses may be limited by the unavailability of sufficient offsetting capital gains.[129] Moreover, this ordinary income recapture will not qualify for installment reporting, and this may have a

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127. *See* I.R.C. § 1245(a)(3)(A) (1988).

128. Section 1245 is broader in scope and more onerous in application than section 1250. It is potentially applicable to property other than livestock whenever the seller's adjusted basis in a particular property reflects adjustments for post-1961 depreciation. Treas. Reg. § 1.1245-2(a)(2)(i) (as amended in 1987). In the case of depreciable livestock, it is potentially applicable to the disposition of livestock with bases reflecting adjustments for depreciation after 1969. Treas. Reg. § 1.1245-1(a)(2)(ii) (as amended in 1971). If it applies, it requires that an amount equal to the lesser of the gain realized on the sale or the total of the depreciation adjustments reflected in the basis be reported as ordinary income. I.R.C. § 1245(a)(1)-(2) (1988). Thus, section 1245 property may be subject to recapture even if only straight line depreciation were used by the seller and even if the property has been fully depreciated at the time of sale.

Like under section 1250, the amount of recapture must generally be computed separately for each item of section 1245 property. Treas. Reg. § 1.1245-1(a)(1) (as amended in 1971). However, all items of section 1245 property in a particular depreciation account may be treated as a single item of section 1245 property in certain circumstances. *See* Treas. Reg. § 1.1245-1(a)(4) (as amended in 1971).

Where multiple properties are sold in one transaction, the total amount realized will be allocated among the various properties on the basis of relative fair market values. Treas. Reg. § 1.1245-1(a)(5) (as amended in 1971). If the seller and buyer have adverse interests as to the allocation, an arm's length agreement between them establishing such allocation will generally control. *Id.* Again, since the section 1245 properties will generally be Class III assets under the section 1060 temporary regulations, an arm's length allocation agreement within that class should generally be respected even where section 1060 controls.

Section 1245 is potentially applicable to all depreciable farm real and personal property other than buildings. I.R.C. § 1245(a)(3) (1988). Section 1245 is also applicable to a "single purpose agricultural or horticultural structure." I.R.C. § 1245(a)(3)(D) (1988). Section 1245 is also applicable to a nonresidential building which was "recovery property" within the meaning of section 168 before amendment by TRA 1986, *if* an accelerated method of depreciation had been used with respect to such property. *See* I.R.C. § 1245(a)(5)(C) (before amendment by TRA 1986).

For further discussion, *see* J. O'BYRNE & C. DAVENPORT, *supra note* 124, at 661-67.

129. *See supra* note 109.

serious adverse consequence to the seller.[130]

The buyer will likely prefer allocation to machinery and equipment because it will generally qualify for the special deduction under section 179 for up to $10,000 of cost[131] and, to the extent not fully deducted under that provision, will generally qualify for accelerated depreciation over seven years.[132]

G. Single Purpose Agricultural and Horticultural Structure

These structures are defined in section 48(q) and accompanying regulations. Typically included are poultry houses, some milking parlors, and some greenhouses.[133] From the seller's standpoint, the tax interests will likely be similar to the seller's interests with respect to farm machinery and equipment since most gain will likely be subject to recapture as ordinary income under section 1245 and will not qualify for installment reporting.[134]

The buyer's interests, too, will be similar to those with

130. I.R.C. § 453(i) (1988). *See* Giljum, *Installment Sales*, Tax Mgmt. (BNA) No. 48-6th, at A-57 to A-59. If the full consideration is paid in the year of sale, the absence of installment reporting would be irrelevant. However, if payments are to be deferred over subsequent years, the absence of installment reporting with respect to recapture under section 1245 and section 1250, but especially with respect to section 1245 since it will likely be the most significant, may mean that the seller is required to report a large part of taxable gains in the year of sale even though receipt of full payment may be deferred over a number of years after the sale. This is certainly a circumstance that should concern the seller in a deferred payment sale, and such seller may want to insist on a larger down payment where substantial recapture will have to be reported in the year of sale.

131. *See* I.R.C. § 179 (1988). The deduction is generally limited to depreciable property that would have qualified for the investment credit under prior law. For a discussion of farm properties that would have qualified for the credit, see Knobbe, *Farm and Ranch Expenses and Credits*, Tax Mgmt. (BNA) No. 208-3d, at A-42 to A-48. Specifically, qualifying property would generally include, assuming the assets were acquired for use in the active conduct of a trade or business, depreciable tangible personal property, elevators and escalators, most other depreciable tangible property, including certain real property improvements but not including buildings and their structural components, livestock other than horses, and single purpose agricultural and horticultural structures. *See* Farmer's Tax Guide, *supra* note 4, at 30-31.

132. *See* Rev. Proc. 87-56, 1987-2 C.B. 674 (assigns a seven-year recovery period to farm machinery and equipment for Asset class 01.1). The initial depreciation rate would generally be 150% of straight line. I.R.C. § 168(b)(1)(B) (1988).

133. *See* Knobbe, *supra* note 131, at A-46 to A-47.

134. Such structures would be section 1245 property. I.R.C. § 1245(a)(3)(D) (1988).

respect to machinery and equipment. The cost allocated to such structures may qualify for the deduction under section 179.[135] Depreciation of the undeducted costs, however, will be over a ten-year rather than a seven-year recovery period as a result of recent legislation.[136]

H. Orchards and Vineyards

If the sale involves an orchard or vineyard, the interests of the seller and buyer may be relatively consistent. The consideration allocated to the trees and vines will generally result in capital gains to the seller, and the amount of ordinary income recapture may largely depend on whether the seller grew the trees or vines or purchased the property with the trees and vines already productive.[137]

Even if there *is* a large ordinary income recapture component with respect to trees and vines, the seller may not have good reason to oppose additional allocations of consideration to them. The recapture component under section 1245 is generally limited to the aggregate amount of allowable depreciation deductions reflected in the seller's basis in the trees or vines.[138] If the trees or vines have appreciated in value, the amount of gain which would avoid recapture as ordinary income may be substantial. Moreover, in that situation it is un-

135. Such structures constitute "section 38 property," which is one of the prerequisites for the deduction under section 179. I.R.C. § 179(d)(1) (1988); I.R.C. § 48(a)(1)(D) (1988).

136. *See* I.R.C. § 168(e)(3)(D) (1988).

137. The trees and vines would be section 1245 property. *See* I.R.C. § 1245(a)(3) (1988). *See also* Beard, *Selected Tax Issues Arising During the Development Stage of Orchards, Groves, and Vineyards*, 38 ARK. L. REV. 73, 121-22 (1984). If the trees or vines had been grown by the seller, it is possible that most of the associated costs were deducted as business expenses and never became a part of the seller's "basis" in the trees or vines. Many preproductive period costs associated with the development of orchards and vineyards were traditionally deductible when paid or incurred. *See* Treas. Reg. § 1.162-12(a) (as amended in 1972). Subsequent statutory enactments limited this privilege with respect to particular types of taxpayers and/or particular types of orchard or vineyard activities. The primary current statutory limitations appear at section 263A.

If most of the preproductive period expenses *had* been deducted and were never capitalized as part of the seller's basis in the trees or vines, there would have been little or nothing to depreciate, and the seller's basis in the trees and vines would reflect few adjustments for depreciation. There would then be little potential for recapture under section 1245.

138. I.R.C. § 1245(a)(1), (2) (1988).

likely that the consideration allocated to the trees and vines could justifiably be reduced enough to significantly reduce the recapture component.[139]

From the buyer's standpoint, the trees or vines that make up the orchard or vineyard—but not the underlying land—will be depreciable, assuming the buyer will continue to use the property for that same purpose.[140] As a result of recent tax legislation, the recovery period for "any tree or vine bearing fruit or nuts" has been set at ten years.[141] However, the change also limits depreciation to the straight line rate.[142] On the other hand, costs allocated to the trees and vines may also qualify for the deduction under section 179.[143]

I. Farm Supplies

If the sale includes farm supplies—such as feed, seed, fertilizer—the gains with respect to the supplies will likely be ordinary income. First, such supplies may not be the type of assets qualifying for capital gains, but rather in the nature of "inventory," although perhaps not literally with respect to a cash method farmer.[144] In any event, it seems that the tax

139. For example, assume that a reasonable allocation to the seller's orchards would produce $100,000 gain with respect to the trees, $50,000 of which would be capital gain and $50,000 of which would be recaptured as ordinary income. Additional allocations to the orchard would not add to the ordinary income recapture, but would rather increase the capital gain. In order to *decrease* the ordinary income recapture, the consideration allocated to the trees would have to be decreased by more than $50,000, since the first $50,000 of decrease would serve only to reduce the $50,000 capital gain component.

140. For a review of the evolution of rules concerning the depreciation of fruit or nut producing trees and vines, although dated now by a few years, see Beard, *supra* note 137, at 116-26.

141. I.R.C. § 168(e)(3)(D)(ii) (1988) (effective for property placed in service after December 31, 1988). TAMRA 1988, *supra* note 96, § 6029(d). Prior to the change there was some uncertainty over the proper classification of trees and vines. H.R. CONF. REP. NO. 100-1104, 100th Cong., 2d Sess. 149 (1988), *reprinted in* 1988 U.S. CODE & ADMIN. NEWS 5209 (1988). Since trees and vines were not previously specifically assigned a recovery life, they could arguably have been either fifteen-year property (as "land improvements, see Rev. Proc. 87-56, 1987-2 C.B. 674 (Asset class 00.3) or seven-year property—property not assigned a class life (I.R.C. § 168(e)(3)(C)(iii) (1988)).

142. I.R.C. § 168(b)(3)(E) (1988).

143. *See* Beard, *supra* note 137, at 129-30.

144. "Stock in trade" and "inventory" are excluded for qualification from capital gains under both section 1221 and section 1231. I.R.C. § 1221(1) (1988); I.R.C. § 1231(b)(1)(A) (1988). The Supreme Court has held that property serving as a substi-

benefit rule would require reporting of ordinary income at least to the extent that the costs of the supplies were previously deducted by the seller as ordinary business expenses.[145] However, the seller may not oppose allocations to previously deducted supplies as long as ordinary income is taxed at the same rate as capital gains.

The buyer, on the other hand, would likely prefer as much consideration as could reasonably be allocated to the supplies be so allocated. If the supplies will be used in the buyer's farming operations, the costs should immediately be deductible as business expenses.[146]

J. Farm Land

As a general rule, the seller may prefer allocations to farm land because the gain may be capital if held for more than one year at the time of sale, while the buyer would resist, based on the nondepreciability of the land.[147] However, gain with respect to farm land that would otherwise be capital may be subject to ordinary income characterization under one or more of several different provisions.[148]

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tute for inventory is covered by the inventory exclusion even though not literally inventory itself. *See* Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955), as limited by Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988).

145. *See* Hillsboro Nat'l Bank v. C.I.R., 460 U.S. 370 (1983). A farm corporation purchased and deducted livestock feed. It subsequently liquidated before all of the feed had been consumed, and distributed its assets, including the unconsumed feed, to its shareholders. The Court held that the tax benefit rule overrode the then nonrecognition rule under section 336, and that the corporation had to increase its taxable income by the cost of the unconsumed feed. Although the primary issue was whether the tax benefit rule would override the statutory nonrecognition rule, it seems clear that the assumption was that any gain recognized under the tax benefit rule would be ordinary.

146. I.R.C. § 162(a) (1988); Treas. Reg. § 1.162-12(a) (as amended in 1972); I.R.C. § 180 (1988). *But see* I.R.C. § 464(f) (1988) (generally deferring the deduction with respect to "excess prepaid farm supplies" until such supplies are used).

147. *See* I.R.C. § 1231(b)(1) (1988) with respect to the character of the seller's gain; *see* Treas. Reg. § 1.167(a)-2 (1960) as to the nondepreciability of land apart from any improvements.

148. Section 1252 may be applicable with respect to the sale of farm land held for nine years or less with respect to which deductions under section 175, for soil and water conservation expenditures, and/or section 182, for land-clearing expenditures before its repeal by TRA 1986, have been allowed. I.R.C. § 1252(a) (1988); Treas. Reg. § 1.1252-1(b)(1) (1976). An amount (up to the gain realized on the sale of the land) equal to a specified percentage of the deductions claimed under section 175 and/or section 182 will be characterized as ordinary income. I.R.C. § 1252(a)(3) (1988).

Section 1255 requires recapture as ordinary income with respect to property "ac-

K. Livestock and Poultry

Generally, gains from the sale of the following livestock may qualify for capital gains treatment under section 1231: (1) Cattle and horses held for draft, breeding, dairy, or sporting purposes and held by the seller for at least twenty-four months;[149] and, (2) other livestock, excluding poultry, held for draft, breeding, dairy, or sporting purposes and held by the taxpayer for at least twelve months from the date of acquisition.[150]

Farm animals not fitting into either of these categories will generally produce ordinary income.[151] Moreover, the livestock listed in (1) and (2) above which may otherwise qualify for capital gains may be subject to ordinary income recapture.[152]

Traditionally, raised production livestock would generally never be depreciated because all costs associated with

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quired, improved, or otherwise modified by the application of payments excluded from gross income under section 126" if such property is sold within nineteen years after the last excluded payment. I.R.C. § 1255(a)(2), (3) (1988). Section 126 permits the elective exclusion from income, under prescribed circumstances, of payments received under certain federal and state cost-sharing conservation programs. The recapture is based on a percentage of the excluded payments, which percentage varies with the time since the last excluded payment was received. I.R.C. § 1255(a)(3) (1988). For additional discussion of these two recapture provisions, see J. O'BYRNE & C. DAVENPORT, *supra* note 124, at 674-77.

Section 1231(c) requires that any net section 1231 gains for a given year, which would otherwise be capital, be recaptured as ordinary income to the extent of the seller's "non-recaptured net section 1231 losses," if any, from the preceding five taxable years. For example, if seller had a net section 1231 loss of $50,000 with respect to the sale of land or other property in 1989 and a net section 1231 gain of $100,000 in 1990, $50,000 of the 1990 gain would be characterized as ordinary. However, if the sales were reversed and the gain sales made in years before the loss sales, the recapture rule of section 1231(c) would not literally apply.

149. I.R.C. § 1231(b)(3)(A) (1988).

150. I.R.C. § 1231(b)(3)(A) (1988). "Livestock" purposes of section 1231 includes hogs, mules, donkeys, sheep, goats, furbearing animals, and other mammals, but excludes poultry, chickens, turkeys, pigeons, geese, other birds, fish, frogs, and reptiles. Treas. Reg. § 1.1231-2(a)(3) (as amended in 1984).

151. For example, if poultry is depreciable, it would be excluded from the definition of capital assets under section 1221(2), but would not qualify as section 1231 property. If the cost of poultry was currently deducted and not depreciated, then a tax benefit rule argument could be made similar to that with respect to previously deducted farm supplies. *See supra* note 145.

152. This livestock would generally be depreciable livestock, if there were ever a depreciable basis in such livestock, and would be section 1245 property in that event. I.R.C. § 1245(a)(3)(A) (1988).

raising such animals would be deducted as business expenses by the cash method farmer when the expenses were paid.[153] There would have been no ordinary income recapture on sale in that event.[154] However, the Tax Reform Act of 1986 added section 263A, which generally required farmers to capitalize (meaning the costs are added to basis and not currently deducted, except through depreciation) the costs associated with raising and maintaining production animals with a preproductive period of more than two years.[155]

The temporary regulations defined preproductive period with respect to farm animals in a way that resulted in most raised production cattle having a preproductive period of more than two years, thus meaning that the maintenance costs would generally *not* be deductible as under prior law.[156] Farmers who were required to use the accrual method were required to capitalize the expenses regardless of the preproductive period of the animals concerned.[157] These new capitalization rules were effective generally for costs incurred after 1986.[158]

As a way of ameliorating the effects of these new rules, farmers not required to use the accrual method were given the option of electing out of the capitalization rules with respect to farm plants and animals otherwise subject to such rules.[159] However, any expenses which were deductible by reason of this election which would otherwise be capitalizable would be subject to recapture as ordinary income on sale of the covered farm animals.[160]

The capitalization rule with respect to farm animals was repealed by TAMRA 1988 as to farm animals raised by farmers not required to use the accrual method, effective with re-

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153. *See* Treas. Reg. § 1.162-12(a) (as amended in 1972).

154. Since the selling farmer's basis in the livestock would reflect no adjustments for depreciation. *See* I.R.C. § 1245(a)(2)(A) (1988).

155. I.R.C. § 263A(d)(1)(A) (1986) as originally enacted by § 803(a) of TRA 1986, *supra* note 7.

156. For example, the preproductive period of a cow is said to begin as early as its conception and end when the now mature cow dropped its first calf. Temp. Treas. Reg. § 1.263A-1T(c)(4)(ii)(C) (as amended in 1987).

157. I.R.C. § 263A(d)(1)(B) (1988).

158. TRA 1986, *supra* note 7, § 803(d).

159. I.R.C. § 263A(e)(3) (1988).

160. I.R.C. § 263A(e)(1) (1988).

spect to costs incurred after December 31, 1988.[161] Thus, production livestock sold by cash method farmers and otherwise qualifying for capital gains treatment may be subject to ordinary income recapture where: (1) The animals were purchased, and later depreciated; (2) costs were deducted during 1987 and 1988 with respect to animals which would otherwise have been subject to the capitalization rules under section 263A except for the election out; or, (3) the election out under section 263A was not made for costs incurred during 1987 and 1988). Thus, these costs became part of the covered animals' basis, and this basis was depreciated when the animals reached their productive stage.[162]

Assuming the animals are subject to ordinary income recapture, the seller's primary concern under current law would likely be where an installment sale is involved, since the recapture amount would not be subject to installment reporting, but would rather have to be reported in full in the year of sale.[163] If capital gains once again become entitled to preferential tax treatment, then the seller would be concerned with the amount of recapture whether or not an installment sale is involved.

The buyer's concerns will differ as between production and nonproduction livestock. As to the former, allocated costs will generally not be deductible as a business expense, but becomes part of the basis of the animals which may be depreciated when these animals are ready to be put into production. The depreciation periods of farm animals vary:

Type	Recovery Period
dairy or breeding cattle	5[164]
breeding hogs	3[165]
breeding sheep and goats	5[166]
horses	3 to 7[167]

161. TAMRA 1988, *supra* note 96, § 6026(b)(1), (2), (d)(2).

162. Notice 88-24, 1988-1 C.B. 491, provided some safe harbor guidelines as to the amount of capitalizable costs with respect to cattle. That is, a farmer could elect to use the guidelines costs in lieu of actual costs.

163. *See supra* note 130 and accompanying text.

164. Rev. Proc. 87-56, 1987-2 C.B. 674 (Asset class 01.21).

165. *Id.* (Asset class 01.23).

166. *Id.* (Asset class 01.24).

167. *See* I.R.C. § 168(e)(3)(A) (1988); *see* Rev. Proc. 88-22, 1988-1 C.B. 785.

The costs of these depreciable animals can be deducted over the applicable recovery period using a depreciation rate that is initially 150 percent of the applicable straight line rate.[168]

Because of the relatively short recovery periods and accelerated rates of depreciation, the buyer will probably prefer allocations of consideration to depreciable production animals. These costs can also qualify for the special deduction under section 179. As to nondepreciable animals, allocated costs will serve only to increase basis available as an offset on disposition of the animals. However, the disposition of the nondepreciable animals may very likely be expected to take place before the production animals will have been depreciated. Therefore, the tax "recovery" with respect to the purchased nondepreciable animals will probably take place even more quickly than with respect to the depreciable animals. The seller's interests with respect to the nondepreciable animals will generally not be adverse to additional allocations of consideration as long as ordinary income and capital gains are taxed in the same manner, and assuming the seller does not have substantial capital losses.

The buyer may have a special interest in allocations of consideration to chickens. These costs will generally be currently deductible by a cash method farmer.[169]

L. Unharvested Crops

Unharvested crops may qualify for capital gains where the underlying land is sold at the same time to the same purchaser.[170] However, a primary concern from the seller's standpoint will be the resulting disallowance of deductions incurred with respect to that crop under section 268.[171] These disallowed deductions are added to the seller's basis in the unharvested crop and will reduce the gain with respect to that crop.[172] The seller will generally prefer allocations to the growing crops because there will be no gain except to the extent the allocated consideration exceeds the basis augmented

168. I.R.C. § 168(b)(2) (1988).
169. *See* Rev. Rul. 60-191, 1960-1 C.B. 78.
170. I.R.C. § 1231(b)(4) (1988). *See also supra* note 107.
171. *See supra* note 107.
172. *Id.*

by the disallowed deductions, and the excess over that basis may qualify as capital gains.

The buyer, on the other hand, will generally also prefer allocations to the growing crops. These costs will not be deductible as business expenses, but will serve as a basis offset against what would otherwise generally be ordinary income to the buyer on sale of the harvested crops.[173] The buyer's costs allocated to these crops, therefore, would be recovered as quickly as the crops are harvested and sold.

M. Other Assets

There may be other assets involved which were not discussed above. For example, a variety of land improvements may be involved. The buyer in particular will be interested in identifying improvements that may be depreciable and insuring that proper consideration is allocated to them. Improvements which have been found depreciable or amortizable include earthen water tanks and dams,[174] certain roads and drainage ditches and terraces built to protect those roads,[175] and some water wells.[176] Improvements may be depreciable because they are constructed with depreciable materials. For example, in the case of tanks, reservoirs, pipes, conduits, canals, dams, wells, or pumps composed of masonry, concrete, tile, metal, or wood.[177]

Commentators have suggested that the buyer may allocate consideration to residual fertilizer applied to the land by

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173. The crop would generally be held for sale within the exclusions of section 1221(1) and section 1231(b)(1)(B).

174. Although the I.R.S. generally takes the position that earthen improvements, such as ponds and dams, are not depreciable (*see, e.g.*, Treas. Reg. § 1.175-2(b) (as amended in 1980); Rev. Rul. 606, 1969-2 C.B. 33, 34, *clarified*, Rev. Rul. 137, 1975-1 C.B. 74), there is some caselaw to the contrary. Earthen water tanks and dams were found depreciable in Rudolph Inv. Corp. v. Commissioner, 31 T.C.M. (CCH) 573, 578 (1972). *See also* Ekberg v. United States, 5 A.F.T.R.2d (P-H) 979, 981 (D.S.D. 1959), *rev'd on other grounds*, 291 F.2d 913 (8th Cir.), *cert. denied*, 368 U.S. 920 (1961) (earthen dams depreciable over ten-year period). *See also* J. O'BYRNE & C. DAVENPORT, *supra* note 124, at 621-22.

175. *See* Rudolph Inv. Corp., 31 T.C.M. (CCH) at 573. The roads were held depreciable because they all led to depreciable buildings and the roads would be abandoned when the buildings were no longer needed.

176. *See, e.g.*, Rev. Rul. 61-206, 1961-2 C.B. 57.

177. *See* Treas. Reg. § 1.175-2(b)(1) which in effect presumes these are depreciable.

the seller and currently deduct or amortize this cost over the remaining life expectancy of the residual supply.[178] On the other hand, the IRS has ruled that costs allocated to summer fallow are considered part of the purchase price of the land, and not deductible or depreciable.[179]

Most of the depreciable land improvements other than buildings and fruit or nut trees and vines, will apparently be assigned a fifteen-year recovery period[180] and qualify for initial depreciation at 150 percent of the straight line rate.[181] Grain bins and fences, on the other hand, have a seven-year recovery period.[182] Most of these land improvements may also qualify for the special deduction under section 179.[183]

The buyer will have most of the incentive to seek out and identify these depreciable land improvements, since the seller would generally benefit if they are simply considered part of the land. Such depreciable land improvements, if identified, may result in ordinary income recapture, and loss of installment reporting.[184]

V. CONCLUSION

It is hopefully clear at this point that the sale of farm properties, like many other types of transactions, may present the possibility of significant possible *alternative* tax consequences for both buyer and seller. The potential flexibility that may exist for allocations of the sales price among the properties sold/purchased may provide the parties with some opportunities to influence what the tax consequences will be. Each is, obviously, likely to be inclined to prefer allocations

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178. *See* Daughtrey & Biebl, *Residual Fertilizer Supply: An Overlooked Element of Land Purchase Price*, 6 J. AGRIC. TAX'N & L. 715 (1985).

179. Rev. Rul. 71-348, 1971-2 C.B. 122.

180. *See* Rev. Proc. 87-56, 1987-2 C.B. 674 (Asset class 00.3 "Land improvements").

181. *See* I.R.C. § 168(b)(2)(B) (1988).

182. *See* Rev. Proc. 87-56, 1987-2 C.B. 674, 677 (Asset class 01.1, "Agriculture").

183. *See supra* note 131.

184. Most of these improvements would be section 1245 property, if at all, per section 1245(a)(3)(B). The recapture under section 1245 is with respect to depreciation "allowed or allowable." I.R.C. § 1245(a)(2)(A) (1988). However, if the seller can show that the amount allowed was less than the amount allowable, recapture can be limited to the amount allowed. I.R.C. § 1245(a)(2)(B) (1988).

that will produce the greatest tax advantage to that party, or which will, at least, minimize any tax disadvantages.

Informed tax advice would include a discussion of the general tax consequences of the sale as well as a discussion of the possible flexibility in allocations, and how that flexibility may be best exercised for the benefit of the particular client. If the tax consequences are going to be the same, regardless of how the transaction is completed, then perhaps no significant harm will be done if the client is not aware, in advance, of what the tax consequences will be. (Although, perhaps, the tax consequences may be significant enough in a given situation that the client may have chosen not to follow through with the transaction at all.) However, if the consequences are both significant and exist in possible alternative form, it is probably much more likely that the uninformed client, whose consequences are more serious than they might have been, will in retrospect feel underserved by any professional advisers who may have been consulted before completion of the transaction.

Under current law, this disappointed party is more likely to be the uninformed buyer, because the buyer usually has the most to gain from an aggressive posture with respect to price allocations. However, it is likely that the seller, particularly if an installment sale is involved, will not want to play a completely passive role in determining any mutually agreed allocations. The seller will, of course, have an even greater stake with respect to such allocations if capital gains are once again given a preferred status under the tax laws.

In any event, at least with respect to the many farm property sales which will involve substantial values, even the *possibility* that potential tax consequences may exist in the alternative makes a failure to address these consequences until after the transaction is completed very difficult to justify.