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Elimination of 1031 Exchanges for Personal Property

One of the changes made in the 2017 tax relief bill was the elimination of Section 1031 for personal property. There are a couple of things that get confused with this. The first is the assumption that Section 1031 exchanges are something done only when trading land properties. The second is that personal property is non-business property when in reality we're talking about personal property vs real property. Personal property used in a business are assets like tractors, combines, pivots, etc. Prior to the start of 2018, when you traded tractors the deferral of gain was allowed under the Internal Revenue Code Section 1031 just like real estate. The difference was usually land exchanges happened over multiple days and multiple transactions instead of a tractor trade that all occurred at the same time as the purchase.

With the elimination of personal property from the rules of Section 1031, there is going to be a significant impact on most farmer's tax returns. Let's look at an example of how a tractor trade will be different in 2018.

New Tractor Purchased	$200,000
Trade In Value of Old Tractor	$150,000
Net Difference or Boot Paid	$50,000

When you go to the dealership to trade tractors, nothing is going to change. You will still write a check (or finance) the difference but the tax return will change.

Tractor Example Using Section 1031 Exchange Rules

Using the rules under Section 1031, we would have taken the remaining value (the original purchase price minus depreciation taken) on the old tractor and added it to the boot paid. Assuming the tractor was depreciated out, the remaining value of the old tractor would be zero so the basis in the new tractor would have been $50,000.

The $50,000 basis would have counted toward the Section 179 limit or been depreciated using regular depreciation and the depreciation would have been added to your expenses on Schedule F (assuming a sole-proprietorship.) If, for simplicity sake, we assume that you were using Section 179, this would amount to a $50,000 deduction on Schedule F which would reduce both ordinary income taxes and self-employment taxes.

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Tractor Example Without Trade Treatment

Starting in 2018, we will have to treat the trade of the tractors as two separate transactions. We will need to start with the sale of the old tractor. Even though you traded the tractor, you will recognize it as a sale on your tax return. Again, assuming the old tractor was depreciated out, the gain on the sale of the tractor would be $150,000. (Gain = Sale price – remaining value) This would be reported on your Form 4797 and treated as ordinary income.

The second transaction is the purchase of a new tractor. Since we've recognized the gain on the sale of the old tractor, our depreciable basis in the new tractor is $200,000. This will be the amount we can use of Section 179 or apply the regular depreciation percentages to. There was concern that this change would have business owners hitting the max Section 179 limit very quickly so we now have a Section 179 limit of $1 million and unlimited Bonus depreciation for both used and new property so we essentially have unlimited accelerated deprecation to use.

Numbers:

	Old Trade Rules	New Rules	Difference
Gain on Tax Return	$0	$150,000	+$150,000
Max Depreciation	$50,000	$200,000	+$150,000
Net Change	$50,000	$50,000	$0

You may be wondering why we're talking about a change that makes no bottom line difference but there are a few things to note.

1. There is a 5-year sunset on the 100% bonus depreciation. (There is a phase out of the percentage between 2023 and 2028.) The $1 million of Section 179 will continue but if you trade a lot of equipment in a year, this could mean that you can't offset the entire gain with extra depreciation.

2. The gain recognized will only be ordinary income (no self-employment taxes) while the depreciation will offset both. This means that if you were recognizing at least $150,000 of income on Schedule F, you will save an extra 15.3% or almost $23,000 in self-employment taxes by recognizing the income and the extra depreciation. This could change the way many farm returns look by showing losses on Schedule F and large gains on the Form 4797. Producers will need to think about using the optional method of calculating SE taxes to make sure they continue to have a history for coverage under the disability rules and it could significantly reduce retirement benefits paid out someday.

3. There are also some unintended consequences from the state level. In Nebraska, we pay personal property taxes based on the Federal Depreciable basis. In the first example, that would have been calculated off the $50,000. Now it will be calculated off the $200,000 basis. This will raise the amount of personal property taxes paid, starting

in 2019. The significance of this will depend on an operation's value of equipment, frequency of trades, etc. In other states, like Iowa, the state income tax calculation does not allow a full deduction of the unlimited depreciation. For producers in those states, you will not be able to offset the gain with additional depreciation so you will need to expect your state income taxes to be higher than in the past.

4. You will also want to change the way you likely keep records. In the past, all we really needed to prepare a tax return is the boot paid or the $50,000 difference. We will now need to know the details of the trade so you will want to include both the purchase price and trade allowance in your records.

So is this a good or back change to the tax rules? In reality, for most producers this is going to be a good change for two reasons, one is the extra self-employment tax savings for Schedule F filers or partnerships and the other is there could be less deferred tax liability for many producers when it's time to end the operation since the recognition of the gain will be taking place with each trade rather than just when you sell the last asset. There will be no benefit of self-employment tax savings for C or S corporations but since they don't pay the tax anyway, they aren't missing out on a benefit. Mostly this will be a change of how we "normally" do things and will take a little while to fully adjust to.

Tina Barrett
Director/Farm Financial Consultant
Nebraska Farm Business, Inc.
tina@nfbi.net
www.nfbi.net