

UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF IOWA

IN RE:)
)
ANDERS H. KNUDSEN, and) Chapter 12
) Bankruptcy No.: 05-03136
CYNTHIA J. KNUDSEN,)
)
Debtors.)

DEBTORS' POST- HEARING BRIEF IN SUPPORT OF CONFIRMATION

This case presents the court the opportunity draw the roadmap to be followed by all future courts and Chapter 12 Debtors for treatment of income taxes arising from the sale of any farm asset used in the Debtor's farming operation. Of necessity, the new roadmap to be drawn by this court differs from the map that existed prior to the enactment of BAPCPA 2005. The pre-BAPCPA treatment of such taxes is illustrated by this court's prior decision *In re Specht*, bankruptcy number 96-21022-D on April 9, 1997.¹ The pre-BAPCPA treatment of income taxes is well documented. It did not provide for the fresh start of the Debtor as the taxes incurred as the result of the sale of farm assets used in the Debtor's farming operation were classified as priority claims that were not dischargeable and had to be paid in full as a condition of confirmation of the Chapter 12 plan.² Congress recognized the ineffectiveness of prior §1222(a)(2) and enacted §1222(a)(2)(A).³ By the enactment of §1222(a)(2)(A) Congress signaled the courts that the old roadmap, which lead to the inevitable dead end -- no discharge

¹ In *Specht*, this Court held that the tax on the proposed post-petition deeding of 80 acres to FSA would lead to taxable income which undermined the plan's feasibility due to the administrative expense in the form of income taxes that the debtors could not pay.

² See, 11 U.S.C. §1222(a) as it existed prior to the enactment of BAPCPA 2005, which read as follows:

- (a) CONTENTS OF PLAN- Section 1222(a)(2) of title 11, United States Code, is amended to read as follows:
(2) provide for the full payment, in deferred cash payments, of all claims entitled to priority under section 507, unless--
(A) the claim is a claim owed to a governmental unit that arises as a result of the sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation, in which case the claim shall be treated as an unsecured claim that is not entitled to priority under section 507, but the debt shall be treated in such manner only if the debtor receives a discharge; or
(B) the holder of a particular claim agrees to a different treatment of that claim; and'

³ Section 1222(a)(2)(A) now reads as follows:

- (2) provide for the full payment, in deferred cash payments, of all claims entitled to priority under section 507, unless--
(A) the claim is a claim owed to a governmental unit that arises as a result of the sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation, in which case the claim shall be treated as an unsecured claim that is not entitled to priority under section 507, but the debt shall be treated in such manner only if the debtor receives a discharge;

for these taxes -- represented by *In re Specht* has been trashed and discarded. Congress has provided some guidance to the court to bound its decision and this cartography project. First of all Chapter 12 was formulated in 1986 as a relief chapter to allow family farmers to reorganize and obtain a fresh start. Thus, the destination of this cartography project is a workable Chapter 12 framework through which family farmers can pass to reorganize their debts and not be left with significant taxes due to the liquidation of farm assets used in their farming operations.

Section 1222(a)(2)(A) is a radical departure from the past treatment of taxes for family farm debtors. Congress's new design is for these taxes to be classified, treated and discharged as unsecured claims not entitled to priority. This court is in the enviable position of being the first to interpret §1222(a)(2)(A). It has a blank road map in front of it upon which it will draw the road to follow to the goal of providing Chapter 12 debtors that obtain a discharge with a "fresh start". It must be careful to avoid the meaningless detours urged by the Internal Revenue Service. Those detours and the inevitable dead ends to which they lead will be explored in this brief. In addition, this brief will present this court with a suggested roadmap for deciding this case and guiding future courts to the goal of providing a "fresh start" to Chapter 12 debtors.

**THE TAXES TREATED UNDER §1222(a)(2)(A) ARE
DISCHARGED NOT MERELY DEFERRED.**

The first detour suggested by the IRS is that the taxes treated under §1222(a)(2)(A) are not discharged, merely deferred until the entry of the order of discharge after which time the IRS is authorized, if not compelled, to seek to collect the unpaid portion of the tax that arises from the sale, transfer, exchange, or other disposition of farm assets used in the debtor's farming operation together with interest and penalties allowed by law.⁴ This detour leads to the dead end of "no fresh start" and can not have been the result intended by Congress. The taxes must be discharged or §1222(a)(2)(A) is meaningless. The court must avoid this IRS detour of mere deferral of the taxes which leads to a very frustrating dead end.

**SECTION 1222(a)(2)(A) APPLIES TO ALL TAXES ARISING FROM THE
DISPOSITION OF FARM ASSETS USED IN THE DEBTOR'S FARMING
OPERATION, NOT JUST "CAPITAL ASSETS" USED IN THE DEBTOR'S
FARMING OPERATION.**

The second dead end detour suggested by the IRS is that only the disposition of assets that result in either capital gains or depreciation recapture qualify for §1222(a)(2)(A) treatment, so called "*capital assets*". Following this detour results in poor policy as tax treatment of sales of various farm assets is not consistent.⁵ Since the holding periods for various types of livestock

⁴ Testimony of IRS bankruptcy specialist Howard Hoy. See Debtor's Exhibits 65, 66, 67 and 68 that outline penalties for Failure to Pay, Interest on Underpayments, Interest, Rates, Tables, and Factors respectively to be followed by the IRS in collecting the unpaid taxes. The penalty on failure to pay is 0.5% per month up to a maximum of 25% of the unpaid tax. 26 U.S.C. §6651(a)(2) as is shown on page 2 of Exhibit 65. This penalty is in addition to the daily compounded interest on the unpaid tax afforded by 26 U.S.C. §6621(a)(2), which is the Federal short-term rate *plus* 3 percent.

⁵ See 26 U.S.C. §1231(b) that defines "property used in the trade or business". §1231(b)(3) provides different holding periods for various classes of livestock as follows:

(3) **Livestock.**--Such term includes--

are not consistent, family farmers with cattle and horses must hold the animals for 24 months in order for the asset to be treated as an asset used in the trade or business, a “*capital asset*” while, farmers with all other livestock, excluding poultry need only hold their animals for 12 months for it to be defined as an asset used in the trade or business, a “*capital asset*”.

All family farmers restructuring their farming operations should be treated the same. Adoption of the IRS definition of “property used in the trade or business” set forth in 26 U.S.C. §1231(b) also known as “*capital assets*” as the interpretation of the bankruptcy code provision §1222(a)(2)(A) will not further sound bankruptcy policy. Bankruptcy code §1222(a)(2)(A) provides favored treatment for taxes that arise as a result of the sale, transfer, exchange, or other disposition of *any farm asset* used in the debtor’s farming operation. Adoption of the IRS suggestion that §1222(a)(2)(A) be limited to “*capital assets*” does not allow all family farmers to be treated the same. There will be disparity between otherwise, similarly situated family farmers, based upon the type of assets they have. In addition, the IRS reliance on “*capital assets*” ignores the word “*any*” that modifies the words “*farm asset*”. Congress could have easily limited the applicability of §1222(a)(2)(A) if it chose to by inserting the word “*capital*” between the words “*any*” and “*farm*” if it intended applicability of the section to be limited to “*capital*” assets.

If the liquidated asset is a “farm asset” used in the debtor’s farming operation, it qualifies for §1222(a)(2)(A) treatment. There should be no disparate treatment under 11 U.S.C. §1222(a)(2)(A) based upon whether the asset was:

- a cow or a pig⁶;
- was held for sale or breeding⁷;
- is an unharvested crop or a harvested crop⁸;
- is real estate or a slaughter hog.⁹

For example, if the animals are held for the appropriate holding periods and are held primarily for draft, breeding, dairy or sporting purposes, the gain or loss is treated under the capital gain-

(A) cattle and horses, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him for 24 months or more from the date of acquisition, and

(B) other livestock, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him for 12 months or more from the date of acquisition.

⁶ The holding period for cows to qualify as assets used in the trade or business is 2 years while it is only one year for pigs. 26 U.S.C. §1231(b)(3)(A) & (B) respectively.

⁷ Assets generally held for sale to another, even if they qualify as breeding animals do not qualify to be treated as assets used in the trade or business. 26 U.S.C. §1231(b)(3)(A) & (B).

⁸⁸ The income from harvested crops is reported on Schedule F and treated as ordinary income. However, unharvested crops sold with land that qualifies as an asset used in the trade or business and held for more than one year can qualify to be treated as “property used in the trade or business.” 26 U.S.C. §1231(b)(4).

⁹ Real estate used in the trade or business and held over one year qualifies as a capital asset and pursuant to the IRS position, would qualify for the favored tax treatment afforded by §1222(a)(2)(A). Slaughter hogs, on the other hand, could never qualify for favored tax treatment afforded by §1222(a)(2)(A) under the IRS position even if they were sold to effectuate a reorganization of the debtor’s farming business. It is unfair to discriminate between the family farmer that needs to liquidate land to effectuate a reorganization and one that must liquidate slaughter livestock to effectuate a reorganization plan.

ordinary loss rule, even if the livestock was included as inventory.¹⁰ Since the holding periods for cattle and other livestock are not the same, two family farmers, one raising hogs and the other raising cattle, and both needing to sell livestock that was held for breeding purposes that is one year and one day old would have very different results under §1222(a)(2)(A) if the IRS position is adopted. The hog producer would be afforded the favorable tax treatment under §1222(a)(2)(A) while the cattle producer would not be eligible for the favored tax treatment.

Dr. Harl testified about the games that could easily be played by hog farmers if they were to retain gilts for breeding, breed them and sell them after farrowing. In the example he cited, many feeder pig producers retain gilts, breed them then sell them after one or two litters, just after they qualify as an asset used in the trade or business, and thereby changing the income from ordinary income to capital gains. Similar games can be expected from potential chapter 12 debtors if this court adopts the IRS detour to determine which assets qualify for favored tax treatment based upon the IRS definition contained in 26 U.S.C. §1231(b)(3).

Growing crops can be treated as §1231 property (assets used in the trade or business) provided that it is growing on land that has been held for more than one year; the land qualifies as “used in the trade or business;” and the crop and land are sold, exchanged, or compulsorily or involuntarily converted at the same time and to the same person. 26 U.S.C. §1231(b)(4). *See also*, Mertens, §22:141. Thus, farmers attempting to change their operation could conceivably grow a crop and sell the land with the growing crop on it to a buyer and have the crop qualify for treatment under 11 U.S.C. §1222(a)(2)(A). When the sale of an asset is dealt with as an asset “used in the trade or business”, it is not subject to self-employment taxes, which can be up to 15.3%.¹¹ The Knudsens, on the other hand, in an effort to change their farming operation, cannot sell their market hogs to allow them to fulfill the terms of the Squealer’s contract that required them to liquidate their hogs and have the income from the sale of the market hogs treated as an asset used in the trade or business pursuant to the IRS suggested definition found in 26 U.S.C. §1231(b)(3). Therefore, if the IRS position is adopted, the favorable tax treatment afforded by 11 U.S.C. §1222(a)(2)(A) would be available to grain farmers selling their growing crops as a part of their real estate instead of harvesting them and selling them in the ordinary course of business is unavailable to the Knudsens and other similarly situated family farmers as a sale of their slaughter animals with the farm does not produce the same tax outcome. The reorganizational opportunities available to family farmers under Chapter 12 should not be determined by the farming enterprise in which they engage. Rather, it should be governed by sound business principals.

Another reason not to adopt the IRS detour suggested by following 26 U.S.C. §1231(b)(3) as the backdrop to determine which assets qualify for the favored tax treatment available under bankruptcy code §1222(a)(2)(A) is that the holding periods for assets to qualify as assets used in the debtor’s trade or business can and do vary from Congress to Congress.¹²

¹⁰ *See*, AmJur Federal Taxation ¶20081; *U.S. v. Ekberg*, 291 F.2d 913, 922 (8th Cir. 1961). Particular attention needs to be afforded to footnote 8 of *Ekberg*, which takes issue with the term “capital asset” and points out that such assets have been carefully described not as capital assets but as items the net gains or which are entitled to capital gains treatment.

¹¹ *See*, 26 U.S.C. §1401(a) & (b) which prescribe Old Age, Survivors, and disability insurance of 12.40% and Hospital Insurance of 2.90% (commonly referred to as Social Security and Medicare respectively).

¹² In 1948 and 1949 the holding period for cattle held for breeding were treated as “capital assets” was six months. 26 U.S.C. §117(a)(1), (b) Internal Revenue Code of 1939. In 1951 Congress amended §117(j) to make it clear that

Illustrations of how the tax code has changed over the years with respect to holding periods and recapture are found in Exhibit "A" attached and incorporated by reference. Bankruptcy policy should be stable and predictable. It would not be stable and predictable if the IRS detour is adopted. The IRS detour is subject to the fickleness of Congressional tinkering with the income tax code is bad policy. Any asset used in a Debtor's farming operation that is sold to effectuate the debtor's restructuring plan should qualify for the favored treatment under §1222(a)(2)(A). This includes the Knudsens' slaughter hogs sold to allow them to enter into the Squealer's contract.

**THE APPROPRIATE METHOD TO DETERMINE THE AMOUNT OF
TAX SUBJECT TO THE FAVORED TREATMENT AFFORDED BY
§1222(a)(2)(A) MAXIMIZES THE TAX CLASSIFIED, TREATED
AND DISCHARGED AS AN UNSECURED CLAIM.**

In yet another detour, the IRS would have this court apply a proration theory that seeks to first separate the income of the debtors into income from the sale what it terms "*capital assets*" from the income from all other sources. Then it seeks to determine the proportion of the income that is from the sale of qualifying "*capital assets*" as a percentage of the total income and apply that percentage only to the income tax portion of the tax bill of the debtors. By doing this, the IRS ignores sound policy that would dictate that "claims of a governmental unit that arises from the sale * * * of farm assets used in the debtor's farming operation" be afforded favorable treatment. As has been demonstrated above, some sales of farm assets used in the debtor's farming operation result in "ordinary income" that is subject to self employment taxes. The sale of other farm assets used in the debtor's farming operation is subject to capital gain while others are subject to depreciation recapture. Under the IRS position, the marginal tax rate system utilized by the United States of America is used against the debtor as a portion of each dollar generated by the sale of farm assets used in the debtor's farming operation is taxes at each progressively higher tax rate instead of at the highest tax rates. Presumably, the debtor would not be selling assets used in the farming operation if it were not necessary to decrease the debt load so that the remaining operation is financially viable. Thus, the income resulting from these

"property used in the trade or business * * * included livestock, regardless of age, held by the taxpayer for draft, breeding or dairy purposes, and held by him for 12 months or more from the date of acquisition. *Gotfredson v. C.I.R.*, 217 F.2d 673, 676 (6th Cir. 1954). The current holding period for cattle is 24 months. 26 U.S.C. §1231(b)(3). Other changes to the holding periods necessary to determine whether assets have been held for use in the trade or business cited in United States Code Service 26 U.S.C. §1231 History; Ancillary Laws and Directives: Amendments, include:

P.L. 98-369, Sec. 1001(b)(15), substituted "6 months" for "1 year" each place it appeared in Code Sec. 1231, effective for property acquired after 6/22/84, and before 1/1/88.

P.L. 94-455, Sec. 1402(b)(1)(R), substituted "9 months" for "6 months" each place it appeared in Code Sec. 1231, effective for tax. yrs. begin. in 1977.

P.L. 94-455, Sec. 1402(b)(2), substituted "1 year" for "9 months" each place it appeared in Code Sec. 1231, effective for tax. yrs. begin. after 12/31/77. Sec. 1402(c) of the Act provided a transitional rule for certain installment obligations (see note at Code Sec. 1222).

In 1969, P.L. 91-172, Sec. 212(b)(1), amended para. (b)(3), effective for livestock acquired after 12/31/69.

Prior to amendment para. (b)(3) read as follows:

"(3) Livestock. Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry."

sales and the resulting tax is taxed at the highest marginal rates and any interpretation of 11 U.S.C. §1222(a)(2)(A) should be classified, treated and discharged as an unsecured claim. This is accomplished through use of the Debtor's pro-forma income tax return method set forth in the chapter 12 plan.

SECTION 1222(a)(2)(A) MUST APPLY TO BOTH PRE AND POST PETITION SALES

The IRS urges one final detour as it argues that only pre-petition transfers that occur in the tax year preceding filing qualify for §1222(a)(2)(A) treatment. This detour makes chapter 12 reorganization through liquidation of assets virtually meaningless unless the liquidation is totally completed well before filing the petition. Bankruptcy is supposed to afford the debtor with the opportunity to have a breathing time to determine its best course of action. The IRS position does not afford the family farmer any breathing time. Rather, it requires the family farmer to determine and execute all parts of its reorganizational plan requiring the liquidation of farm assets used in the farming operation in the tax year prior to filing the chapter 12 case. Congress could not have intended such a result. In many instances it will be necessary for the family farmer to sell some of its assets to allow it to retain the others when the plan is complete. Thus, the tax should be viewed as an administrative priority tax treatable under §1222(a)(2)(A). This court should not take this final detour, as it like all the others leads it away from the goal of affording family farmers a fresh start.

CONCLUSION

This court has the unique opportunity to draw the map that will guide debtors and other courts within the boundaries established by Congress when it enacted Chapter 12 and modified it in 2005 through passage and enactment of §1222(a)(2)(A) to the goal of meaningful reorganizational opportunities within Chapter 12. As this court well knows, when Chapter 12 was passed its goal was to afford farmers a viable alternative to the unworkable morass of Chapter 11. Unfortunately, as originally passed, Chapter 12 did not work as well as it should have worked as the income tax consequences of liquidation of farm assets used in the debtor's farming operation led to unconfirmable plans and dismissals. Congress has observed the problem and proscribed §1222(a)(2)(A) as the solution. This court must determine the proper course to follow that avoids the IRS detours leading away from the goal of meaningful fresh starts and provides the maximum opportunities for family farmers to reorganize through Chapter 12. To accomplish this cartography project successfully, and avoid the IRS detours while providing a sound policy basis for its decision, this court should confirm the Knudsen's Fifth Amended Chapter 12 Plan of Reorganization and in so doing conclude the following:

1. The Knudsens' plan meets the requirements of Chapter 12;
2. The plan is feasible;
3. The plan does not unfairly discriminate;
4. The proper definition of farm assets used in the debtor's farming operation is not dependent upon the IRS code definition of "capital assets" as is urged by the IRS as it unfairly discriminates between otherwise similarly situated family farmers based upon the farming enterprise in which they are engaged and the "games" they are

willing to play. Rather it should be based upon sound business policy which allows the family farmer to determine which assets must be liquidated to most effectively reorganize irrespective of whether the income is reported on schedule F, Schedule D or Form 4797 and regardless of whether the tax is capital gains, depreciation recapture, ordinary income or self-employment income;

5. Section 1222(a)(2)(A) must apply to both pre-petition and post-petition sales of farm assets used in the debtor's farming operation or chapter 12's usefulness will be virtually neutered;
6. The proper methodology to determine the amount of tax that is to receive the favored treatment pursuant to §1222(a)(2)(A) has been proposed by the debtors as it recognizes that the income from the sale of farm assets used in the debtor's farming operation will generally be additional income over and above the income that the debtor would have absent the reorganization that occurred either prior to or as a part of the chapter 12 case; and,
7. The chapter 12 discharge discharges the taxes afforded Section 1222(a)(2)(A) treatment prohibiting the governmental unit from seeking to collect any portion of the tax not paid as a part of the chapter 12 plan.

Dated this 18th day of August, 2006.

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CERTIFICATE OF SERVICE

I hereby certify that a copy of the document on which this appears and all enclosures, was either delivered by the Court's CM/ECF System or faxed to the parties in interest listed as required by the Bankruptcy Code and Rules by:

August 18, 2006

/s/ Joseph A. Peiffer
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Part 5 INCOME TAXATION OF FARMERS

Chapter 31 The Recapture Provisions--I.R.C. Sections 1245, 1250, 1252, 1255

4-31 Agricultural Law § 31.01

§ 31.01 Introduction

The Internal Revenue Code contains four income tax recapture provisions directly affecting the farmer as a taxpayer. When any one of the major provisions applies, the farmer may find that gain otherwise taxed at capital gain rates is subject to ordinary income treatment.¹ This chapter discusses each Code section and explains how "recaptured" income is reported on the return.

Prior to 1962, as today, a taxpayer could apportion the cost of a depreciable business asset over its useful life by way of an annual depreciation deduction which could be used to offset ordinary income. Unlike present tax treatment, however, before 1962, after depreciating the asset, the taxpayer could dispose of it and obtain capital gain treatment.

Example: In 1957, a taxpayer purchased a tractor for \$ 8,000. The tractor had a useful life of five years and a salvage value of \$ 2,000. Using straight-line depreciation, after three years the taxpayer would have taken \$ 3,600 in depreciation deductions, thereby offsetting other ordinary income by that amount. When the taxpayer sold the asset for \$ 6,000, the \$ 1,600 gain (\$ 6,000 minus the adjusted income tax basis of \$ 4,400) was taxed at capital gain rates.²

The net effect was that taxpayers could turn ordinary income into capital gain by rapid depreciation followed by sale of the asset. Congress determined that much of this benefit should be eliminated and enacted a depreciation recapture provision (I.R.C. § 1245) in 1962 and another recapture provision (I.R.C. § 1250) in 1964. The former generally pertains to tangible personal property and the latter to real property. Under these sections, part or all of the gain attributed to depreciation is taxed at ordinary income rates. In the example

¹ Gain from the sale or exchange of capital assets or depreciable trade or business property is given favorable tax treatment if the property has been held for the requisite period. That period is: (1) more than one year for most capital assets or assets held for use in the trade or business; (2) 12 months or more for livestock held for draft, dairy, breeding or sporting purposes except for horses and cattle; and (3) 24 months or more for horses and cattle eligible for capital gains treatment.

For income tax treatment of gains and losses from commodity futures contracts, both from hedging and speculation, see § 27.03[8][d] *supra*.

An individual taxpayer was entitled to a deduction equal to 60 percent of the gain through 1986. I.R.C. §§ 1202, 1231. See *n.12, infra*, and accompanying text.

² The tractor would be Section 1231 property: it is used in the taxpayer's trade or business, i.e., farming; it is depreciable; and it has been held for more than one year. I.R.C. § 1231(b). Therefore, gain on the sale of the tractor is treated as gain from the sale of a capital asset. I.R.C. § 1231(a).

above, since the entire gain was due to the depreciation deduction, all of the \$1,600 gain would be taxed as ordinary income to the extent the depreciation had been claimed after 1961, the effective date of the first recapture provision.

To the extent farmers dispose of depreciable assets, recapture may pose a problem. Part of the economic advantage of claiming depreciation deductions against ordinary income, with taxation of the gain as capital gain, was removed with institution of the recapture rules commencing in 1962. The effects of recapture were substantially greater for high tax bracket investors than for those in lower income tax brackets. For both classes of taxpayers, recapture left one advantage of rapid depreciation intact. The recapture rules do not require that an allowance be included for interest on the tax paid because of the recapture of gain as ordinary income. Thus, fast depreciation still represents interest-free use of funds that would otherwise have been paid in tax. Despite commencement of recapture in 1962 and 1964, a great deal of investment activity by nonfarm investments has been evident in agriculture, particularly in livestock which was originally exempt from recapture, but was made subject to recapture for depreciation claimed after 1969.³

Sentiment in the late 1960's was running high among many groups and members of Congress against the use of investment in farm assets as a device to shelter income. This sentiment resulted in the Tax Reform Act of 1969, which added several additional provisions designed to curb tax shelter investments in addition to extending the recapture rules to livestock. The Act created several provisions affecting investors and farmers alike. Among these were:

- (1) a provision (I.R.C. § 1251) , requiring that gain on the disposition of certain farm property be recaptured (i.e., treated as ordinary income instead of capital gain) to the extent that pre-1976 farm losses had been used to offset nonfarm income (the provision was repealed in 1983);
- (2) a provision (I.R.C. § 1252) , requiring that all or part of the gain from the sale of land held less than ten years be recaptured if the seller had expensed, rather than capitalized, soil or water conservation expenditures or the costs of clearing the land;
- (3) several important provisions discussed elsewhere (see § 30.06), such as rules on hobby losses;
- (4) a change in the recapture rules for depreciable real property; and
- (5) an increase in the holding period for cattle and horses to obtain long-term capital gain treatment.

In general, the provisions were designed to discourage nonfarmers from entering into farming operations solely for the purpose of taking advantage of the special farm deduction provisions. For example, before 1970, nonfarmers could buy uncleared land or land needing soil conservation work, obtain substantial tax benefit in offsetting nonfarm income by making improvements and electing to deduct land preparation expenditures, and sell the parcel involved with capital gain on the profits. The recapture rules provide that deducted amounts may be recaptured on disposition of the land, thus removing much of the benefit of early deductions coupled with later long-term capital gains.⁴ Under the "Excess Deductions Account" rules, adopted in 1969, for net farm losses above an exemption amount, all gain

³ I.R.C. § 1245.

⁴ I.R.C. § 1252. See § 31.05 *infra*.

on the sale of "farm recapture property" was ordinary income, to the extent of the losses.⁵ The "Excess Deductions Account" rules rarely applied to bona fide farmers and were repealed in 1983.⁶

The Tax Reform Act of 1976 also limited farm investments as tax shelters, with a further tightening of recapture for depreciable real property. In 1982, penalties were added for promoting abusive tax shelters, injunctions were authorized against promoters of abusive tax shelters and penalties were imposed for substantial understatements of tax.⁷

The Revenue Act of 1978 added a recapture provision for government cost-sharing payments excluded from income.⁸ Section 1255 of the Internal Revenue Code recaptures as ordinary income part or all of the gain on disposition within 20 years of property "acquired, improved, or otherwise modified" by payments excluded from income.⁹ The Economic Recovery Tax Act of 1981 maintained the basic recapture concepts under the Accelerated Cost Recovery System (A.C.R.S.) which was in effect for property placed in service after 1980 and before 1987, with limited exceptions.¹⁰

Under the Tax Reform Act of 1986, the recapture rules under Section 1245 were continued. All gain on the disposition of Section 1245 property is recaptured as ordinary income after 1986, to the extent of depreciation deductions previously allowed, not merely all gain representing depreciation taken since 1962.¹¹

The Tax Reform Act of 1986 also repealed the 60-percent exclusion for long-term capital gains income for individuals, effective in 1987.¹² A maximum rate of 28 percent on net long-term capital gains income was enacted in 1990, effective in 1991.¹³

Legislation in 1997 increased the holding period for long-term capital gain treatment after July 28, 1997, from "more than one year" to "more than 18 months."¹⁴ However, the holding period was returned to "more than 1 year" effective for taxable years ending after December 31, 1997.¹⁵ The holding period for livestock remained unchanged for long-term capital gains treatment (12 months or more for eligible hogs and sheep, 24 months or more for eligible cattle and horses).

Some of the 1969 Act sections continue to have an effect on farmers. Several of the Code provisions outlined in prior chapters afford farmers special benefits which are lessened when the recapture provisions come into play. Good tax planning requires an awareness of which acts trigger a particular recapture provision, what the potential effects of recapture are, and the interplay among the "recapture" Code sections. Quite clearly, the pressure to convert deductions from ordinary income into capital gain is greater when capital gains are subject to preferential treatment, which has again been the case since 1997.

⁵ I.R.C. § 1251. This recapture is caused only by pre-1976 farm losses. See § 31.04 *infra*.

⁶ See § 31.06 *infra*.

⁷ Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, §§ 320, 321, 323, 96 Stat. 611-615 (1982).

⁸ I.R.C. § 1255, added by Pub. L. No. 95-600, § 543(c)(1), 92 Stat. 2890 (1978).

⁹ I.R.C. § 1255(a)(1), (2).

¹⁰ Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 204, 95 Stat. 222 (1981), amending I.R.C. §§ 1245, 1250.

¹¹ Pub. L. No. 99-514, § 201(d)(11)(A), 100 Stat. 2139 (1986), amending I.R.C. § 1245(a).

¹² Pub. L. No. 99-514, § 301(a), 100 Stat. 2142 (1986), repealing I.R.C. § 1202.

¹³ Pub. L. No. 101-508, § 11101(c), 104 Stat. 1388-403 (1990), amending I.R.C. § 1(j).

¹⁴ I.R.C. § 1(h).

¹⁵ I.R.C. § 1(h)(6), added by Pub. L. No. 105-206, § 5001, 112 Stat. 787 (1998).