



## How Does the New Tax Law Act Impact Equipment Trades?

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Kristine A. Tidgren

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The Tax Cuts and Jobs Act preserved like-kind exchange treatment for real property, but eliminated it for personal property. Today, we take an initial look at what that means for farmers or other taxpayers looking to trade equipment or livestock in 2018. We will soon write separately about vehicle depreciation and trades in light of the new law.

### Pre-Tax Cuts and Jobs Act Law

Under 2017 law, IRC § 1031 non-recognition treatment was mandatory for a qualifying exchange of personal property. Those who did not want to apply §1031 like-kind exchange rules to a trade typically had to structure the transaction as a clear sale and purchase to avoid being automatically deemed a like-kind exchange by IRS and the courts. Taxpayers could generally accomplish this by selling the old asset to a different party than the one from whom the new asset was purchased.

With a §1031 exchange, gains or losses on the exchange of like-kind personal property used in a trade or business were generally deferred. This meant that if a farmer traded a fully depreciated piece of equipment for a newer model, the like-kind exchange rules applied, and recognition of IRC § 1245 recapture was deferred. If a farmer traded several raised breeding heifers for some like-kind cows, § 1231 gain would be deferred on that transaction as well. In a like-kind exchange, the basis of the relinquished property was carried over to the basis of the replacement property, and gain recognition was rolled ahead until such time as the replacement property was sold. Specifically, the basis of the replacement property was equal to:

$$\text{Basis of the relinquished property} - \text{Boot received} + \text{Boot paid} + \text{Gain recognized} - \text{Loss recognized}$$

Gain (but not loss) was *recognized* only to the extent that the boot received exceeded the gain realized. A loss was *recognized* only if property given was not like-kind and the adjusted basis exceeded its FMV.

A basic example illustrates this formula:

In 2017, John traded a tractor with a FMV of \$75,000 and an adjusted basis of \$0 for a tractor with a fair market value of \$125,000, plus \$50,000 in cash.

Under old law, applying automatic like-kind exchange treatment, IRC § 1245 recapture was deferred, and the basis in John's replacement tractor was **\$50,000** (\$0 basis in relinquished tractor, plus boot paid). John reported the transaction on Form 8824, and could generally use IRC § 179 to immediately expense \$50,000, the amount of boot paid in the transaction.



## New Law

The Tax Cuts and Jobs Act, H.R.1, amended IRC § 1031 by striking the word “property” and replacing it with “real property.” This means that like-kind exchange treatment is still alive and well for real property, but it is gone *permanently* for personal property, beginning in 2018.

A transition rule provides that a qualifying personal property exchange where either the property was disposed of or received by the taxpayer on or before December 31, 2017, is still subject to like-kind exchange treatment. With no § 1031 treatment available to personal property in 2018, equipment or livestock “trades” will be treated as taxable events, with the taxpayer computing gain or loss based upon the difference between the amount realized on the sale of the relinquished asset and the party’s adjusted basis in the asset. “Amount realized” includes any money, as well as the fair market value of property (other than money) received in the transaction. IRC §1001(b). There will be no tax deferral for §1231 gains or §1245 recapture. There will also be no deferral for a loss.

### ***Enhanced Bonus Depreciation and Expensing Options***

Increased expensing and bonus depreciation options must be considered in assessing the overall impact of the loss of the 1031 exchange for personal property. The Act generally allows just over five years of 100 percent bonus depreciation for qualifying property acquired and placed into service after September 27, 2017 (taxpayers can elect to use 50 percent bonus for 2017 purchases). Beginning in 2023, the Act would then allow one year of 80 percent bonus, one year (2024) of 60 percent bonus, one year (2025) of 40 percent bonus, and one year (2026) of 20 percent bonus. After that time, bonus depreciation will end. Important for this purpose, the Act provides that the enhanced first-year additional depreciation property provisions apply to *used* property, as well as new property (beginning with property acquired and placed into service after September 27, 2017).

Beginning in 2018, the Act also expanded Section 179 to provide an immediate \$1 million deduction (up from \$510,000 in 2017) with a \$2.5 million phase-out threshold (up from \$2,030,000 in 2017). These amounts will be indexed for inflation beginning in 2019. These provisions are not set to expire.

### ***Example of “Trade” under New Law***

The following example illustrates 2018 tax treatment of an equipment “trade” in light of the new law:

In 2018, John “trades” a tractor with a FMV of \$75,000 and an adjusted basis of \$0, plus \$50,000 cash for a tractor with a fair market value of \$125,000.

In 2018, this transaction will be treated as a sale and a purchase. John must now recognize \$75,000 in § 1245 recapture (the difference between the FMV of the traded tractor (\$75,000) and its adjusted basis (\$0)). This transaction will be reported on Part III of Form 4797 and taxed as ordinary income (no self-employment tax). John uses the proceeds of the sale, plus an extra \$50,000 in cash, to purchase the new tractor. Thus, John’s basis in his new tractor will be **\$125,000**, the full purchase price of the new tractor. John can likely use IRC § 179 to expense this amount in 2018. If Section 179 is not available, he can use 100 percent bonus to capitalize and depreciate the full amount in 2018.

## Other Considerations

In 2017 and 2018, John from our above examples will have the same total income on his Form 1040. However, the difference between a § 1031 exchange and a sale and purchase is not one without distinction.

### **Self-Employment Tax Considerations**

Choosing to apply higher amounts of IRC §179 or bonus depreciation to offset the recognized § 1245 gain will result in lower net Schedule F income, thereby reducing SE income. While this means less SE tax, it also means less retirement income down the road. This is an important planning consideration.

In the 2017 example above, assume John otherwise had \$125,000 in net Schedule F income. With like-kind exchange treatment, John deferred \$75,000 in § 1245 gain, and expensed \$50,000 (the cash boot paid). This meant that John's Schedule F income was reduced to \$75,000. This income is subject to SE tax.

In 2018, also assume John otherwise has \$125,000 in net Schedule F income. Now he must recognize the \$75,000 in recapture income, which is not reported on Schedule F, but on Form 4797, Part III. But John can now expense (or depreciate using bonus depreciation) the full amount of his \$125,000 purchase on Schedule F. This will result in \$0 in Schedule F income and no SE tax liability.

### **New 199A Deduction Considerations**

The new IRC § 199A creates a new deduction for "qualified business income." This deduction can generally be taken in an amount up to 20 percent of "qualified business income." It does appear that IRC § 1245 recapture reported as gain on Form 4797 should qualify as a component of qualified business income. QBI is defined as the "net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. Such term shall not include any qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income." IRC § 199A(c)(1). The law also excludes wages, reasonable compensation, guaranteed payments, interest income, dividend income, and capital gain from the definition of QBI. IRC § 199A(c)(3)(B). Although the exclusion does not mention § 1231 gain, it seems likely that IRS regulations will specify that such gain is also excluded from the definition of QBI since it is taxed like capital gain. Regulations will further define the contours of this deduction in many ways.

### **Loss Considerations**

The sale/purchase treatment (as opposed to the like-kind exchange treatment), may be useful in some cases to create ordinary income to offset a net operating loss carryforward. Careful planning is necessary to properly handle expensing and depreciation elections in light of other income.

### **Reporting of the Sales Price**

In the past, the *adjusted basis* of the relinquished property was reported on Form 8824 and carried forward to the replacement property. That number was readily available from depreciation schedules. Now, the *gross sales price* of the property must be reported on Form 4797, in addition to the adjusted basis. Under IRC § 1001(b), the sales price should equate to the fair market value of the relinquished property. In other words, an accurate trade-in value will be important. We will be watching to see if IRS issues regulations governing the reporting of exchanges in light of the new law.

### **Permanent v. Temporary**

The elimination of like-kind exchange treatment for personal property is permanent, as is the enhanced IRC § 179 deduction. 100 percent bonus depreciation, however, is available only through 2022 before it begins to taper down. It will be eliminated fully in 2027. In any event, permanent or temporary only means until the next Congress changes its mind.

### **Exchanges Occurring Between September 28, 2017, and December 31, 2017**

As noted above, 100 percent additional first year depreciation is available to qualifying property acquired and placed into service after September 27, 2017. This includes used property. Consequently, there is a three-month window (for individual calendar year taxpayers) where 100 percent bonus depreciation and IRC §1031 treatment for like-kind personal property coexist. The new law allows 100 percent bonus to apply *only* to the boot paid in such like-kind exchanges. This is because IRC § 168(k)(2)(E)(ii) states that property qualifying for bonus depreciation must meet the requirements of IRC § 179(d)(3), which states that "the cost of property does not include so much of the basis of such property as is determined by reference to the basis of other property held at any time by the person acquiring such property." This is true whether the taxpayer elects to take 100 percent bonus or 50 percent bonus, as is available during the first tax year ending after September 27, 2017, under IRC § 168(k)(10).

*Note:* For assets purchased before September 28, 2017, 50 percent bonus would apply to both the boot and the adjusted basis of the relinquished property, although section 179 could only be used to expense the amount of the boot paid.

Of course, after September 27, 2017, taxpayers may continue to elect *no* bonus depreciation for any class of property. § 168(k)(7). Such election, once made, can be revoked only with the consent of IRS.

### ***Impact of State Taxation***

How states choose to respond to the new federal tax laws will have large implications for taxpayers. In Iowa, for example, the State legislature has not conformed to federal tax law after January 1, 2015. Additionally, Iowa has chosen not to couple with federal bonus depreciation. This means that currently, Iowa allows a \$25,000 Section 179 deduction, with a \$200,000 threshold and no bonus depreciation.

It is expected that Iowa and many other states will choose not to couple with the new federal § 179 of \$1,000,000 and 100 percent bonus depreciation. Thus, even though federal expensing and depreciation enhancements can help to lessen the blow of the loss of non-recognition of gain on like-kind exchanges for personal property, Iowa law may not. And more use of increased expensing and 100 percent bonus will merely exacerbate the problem down the road. Although Iowa taxpayers can generally expense up to \$25,000 and then depreciate an asset acquired in a trade using MACRS, they could see significant differences between state and federal taxable income if they must recognize large amounts of IRC § 1245 recapture income because of a trade. This is an issue we are watching closely.

We will keep you posted!

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