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Comments

THE FARM TAXPAYER AND THE INVESTMENT CREDIT: ELIGIBLE PROPERTY

The Revenue Act of 1962 contributed several major reforms to our system of federal taxation, the most significant being the investment credit.[1] Although recent legislation suspends the investment credit for a fifteen month period,[2] this should have little effect on the average farm taxpayer because property qualifying for the credit in the aggregate cost of $20,000 is exempt from suspension.[3] Property on which an investment credit is available is called section 38 property. It is defined in section 48(a)(1) as:

> (A) tangible personal property, or
> (B) other tangible property (not including a building and its structural components) but only if such property—
> (i) is used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water or sewage disposal services, or
> (ii) constitutes a research or storage facility used in connection with any of the activities referred to in clause (i). . . .
> Such term includes only property with respect to which depreciation (or amortization in lieu of depreciation) is allowable and having a useful life (determined as of the time such property is placed in service) of 4 years or more.

The tangible personal property on which the credit may be claimed is broadly defined as "any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures, including items which are structural components of such buildings or structures."[4] Property within this definition is section 38 property for federal income tax purposes even though it constitutes a fixture under local law.[5]

The typical farmer will usually have many items of tangible personal property that will qualify for investment credit treatment, the most obvious example being machinery, and equipment. Thus, a tractor, plow, disc, combine, portable hay or

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1. The Secretary of the Treasury, in his appearance before the Senate Finance Committee stated, "The central element of the bill [Revenue Act of 1962] is the tax credit for investment in depreciable machinery and equipment." S. REP. No. 1881, 87th Cong., 2d Sess. 1 (1962).
2. Internal Revenue Code of 1954, §§ 48(j), 48(h)(1) and (2). (The Internal Revenue Code is hereinafter cited as I.R.C.)
3. I.R.C., § 48(i)(1). The $20,000 limit applies to the fifteen month period and the taxpayer may select the items to which he wants the exemption to apply.
4. Treas. Reg. § 1.48-1(c) (1964), as amended, T.D. 6838, 30 Fed. Reg. 9060 (1965).
5. *Ibid.*

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grain elevator, etc., will qualify as long as it has a useful life of at least four years.

A milking machine should qualify as section 38 property, even though the pipeline and engine are often attached to the dairy barn in such a manner as to be classified as fixtures under local law. As noted above, classification of the property under local law is irrelevant. Therefore, the machine, pipeline, and engine would all qualify as tangible personal property since they are not structural components of the barn in which they have been installed. Although the cows utilized in the dairy operation are within the literal definition of tangible personal property, it is clear that neither they nor any other kind of livestock will qualify because they are specifically exempted.[6]

Because of the large volume of gasoline used in the farming operation, many farmers have installed gas pumps of the type found in older gasoline stations. Such a pump should qualify for the credit because all property "in the nature of machinery (other than inherently permanent structures) is considered to be tangible personal property even though located outside of a building."[7] As will be pointed out later, the underground gas storage tank used in conjunction therewith will qualify for section 38 treatment under section 48(a)(B)(ii).

A large scales of the type used to weigh hay and grain by the truckload should also qualify because it is essentially in the nature of machinery and not an inherently permanent improvement made on the land.

A farmer may have "other tangible property," as set out in section 48(a)(1)(B), which qualifies as section 38 property. Such property does not include a building and its structural components,[8] but does include "other tangible property" used as *an integral part* of manufacturing, production, or extraction.[9] It also includes "other tangible property" used as a research or storage facility[10] if such property is used *in connection with* any of the foregoing processes.[11] Here, almost anything classified as a part of the real estate under local law will qualify if it is not a building.

To determine what property qualifies for investment credit treatment when used in the production process one must determine what "other tangible property" is used by farmers as *an integral part* of this process. Property is used as an integral part of production when it is used directly in the production process *and* is essential for the completeness of such process.[12] A fence would qualify here as section 38 property because it is used directly in the production of livestock and is essential to such production.[13] Other tangible property which would seem

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6. I.R.C., § 48(a)(6).
7. *Supra* note 4.
8. I.R.C., § 48(a)(1)(B), Treas. Reg. § 1.48-1(d) (1964), as amended, T.D. 6838, 30 Fed. Reg. 9060 (1965).
9. I.R.C., § 48(a)(1)(B)(i), Treas. Reg. § 1.48-1(d) (1964), as amended, T.D. 6838, 30 Fed. Reg. 9060 (1965).
10. I.R.C., § 48(a)(1)(B)(ii), Treas. Reg. § 1.48-1(d) (1964), as amended, T.D. 6838, 30 Fed. Reg. 9060 (1965).
11. *Ibid.*
12. Treas. Reg. § 1.48-1(d)(4) (1964), as amended, T.D. 6838, 30 Fed. Reg. 9060 (1965).
13. *Ibid.*

to satisfy the integral part requirement would be "tile drains, feeding floors and installations, water systems outside of a structure, outside power and light systems, depreciable parts of ponds, dams, or drainage ways and gates."[14] Terraces should also qualify.

The second broad category of "other tangible property" which qualifies as section 38 property under section 48(a)(1) is that used as research or storage facilities *in connection with* the production process. Storage facilities do not have to be used as an integral part of the production process; it is sufficient that they be used in connection therewith.[15] Such property will qualify as long as it is not a buliding. Thus, the gas storage tank referred to earlier would qualify here, as well as grain storage bins.[16] The type of grain storage bin being referred to is evidently the type popularly known as a "steel bin" or a "steel grainery."

While it might seem that a grain storage bin is a building, and, therefore, not section 38 property, the regulations specifically state that a grain storage bin is not a building.[17] A building is "any structure or edifice enclosing a space within its walls and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, display, or sales space."[18] A structure is not a building if it is essentially an item of machinery or equipment, or if it is an enclosure which is so closely combined with the machinery or equipment which it supports, houses, or serves that it must be replaced, retired, or abandoned contemporaneously with such machinery or equipment, and is depreciated over the life of such equipment.[19]

It would seem that a grain dryer would qualify here, as would a grain storage bin which features an automatic augering system for loading and unloading grain, because both structures are used as storage facilities and are essentially items of machinery or equipment. Such structures cannot readily be converted to an alternate use by farmers. They are not buildings within the statutory definition because they must be abandoned contemporaneously with the removal of their working apparatus.

There are many grain storage bins used on farms that have no augering systems with which to load and unload grain. Since the regulations specifically say that grain storage bins are not buildings,[20] a farmer probably can claim an investment credit on a non-mechanized bin. However, it can be argued that this type of grain storage bin does not qualify because it is within a class of property specifically excluded from section 38 treatment, namely buildings. It is a structure or edifice enclosing a space within walls and covered by a roof. Since it has no mechanical apparatus, it is not essentially an item of machinery or equip-

14. O'Byrne, FARM INCOME TAX MANUAL 324 (3d ed., 1964).
15. Treas. Reg. § 1.48-1(d)(5) (1964), as amended, T.D. 6838, 30 Fed. Reg. 9060 (1965).
16. *Ibid.*
17. Treas. Reg. § 1.48-1(e) (1964), as amended, T.D. 6838, 30 Fed. Reg. 9060 (1965).
18. *Ibid.*
19. *Ibid.*
20. *Ibid.*

ment, and does not come within the exception noted. This type of grain storage bin would seem to be analogous to a barn, which does not qualify as section 38 property even though it may be used in the farming operation as a storage facility for either grain or hay.[21]

Since a non-mechanized grain storage bin is not essentially an item of machinery or equipment, it could only qualify for section 38 treatment in one of two ways. First, the statute could be interpreted as saying that a storage facility qualifies whether or not it is a building. If this interpretation is adopted, a hay barn should also qualify, but barns are specifically exempted from investment credit treatment. Both the language of the statute[22] and the interpretation of it by the regulations[23] indicate that a storage facility does not qualify if it is a building. An examination of the legislative history of the Revenue Act of 1962 indicates that this is the interpretation which Congress intended be given the statute.[24]

It can also be argued that a non-mechanized grain storage bin will qualify as section 38 property even though it is a structure or edifice enclosing a space within walls, since the definition of a building can be interpreted as excluding this type structure. The examples of buildings given in the regulations are structures "the purpose of which is, for example, to provide shelter or housing, or to provide working, office, display, or sales space."[25] A non-mechanized grain storage bin is not designed for the purpose of providing "working, office, display, or sales space." Nor is it used for the purpose of providing "housing." Furthermore, although it does protect grain stored therein from the elements, such a structure is not designed to provide "shelter" in the sense that a barn does. Therefore, if the examples used in the regulations are interpreted as setting out the exclusive purposes for which a structure can be used if it is to be classified as a building, a non-mechanized grain storage bin might not be within the definition of a building. If this interpretation is adopted, such property would qualify because it is "other tangible property" used in connection with the production process as a storage facility.

However, it would seem difficult to place such an interpretation on the regulations since they do not purport to be exclusive. On the contrary, the use of the words "for example" indicates that such purposes are not to be interpreted as precluding a structure used for other purposes being classified as a building.

With these factors in mind, can a farmer properly rely on the literal language of the regulations which state that a grain storage bin is section 38 property, and claim an investment credit on a non-mechanized bin? If so, is the allowance of the credit consistent with the stated intention and purpose of the statute? These are questions which cannot be answered without further clarification from the government as to the exact interpretation being given the statute.

21. *Ibid.*
22. I.R.C., § 48(a)(1)(B).
23. *Supra* note 17.
24. 2 U.S. CODE CONG. & AD. NEWS 3400 (1962).
25. *Supra* note 17.

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The regulations specifically say that a silo is not a building;[26] Consequently, the ordinary upright silo would seem to qualify since it is so closely combined with the mechanical facilities used to fill and empty it that it would have to be abandoned contemporaneously with the removal of its working mechanism. It cannot readily be converted to an alternate use by a farmer.

The real problem in this area would seem to be whether a trench silo qualifies as section 38 property. Trench silos are basically of two types: one is merely a hole in the ground, while the other is on top of the ground and of cement construction. Neither type is covered by a roof. Thus, trench silos are apparently not buildings, but rather qualify for section 38 treatment as "other tangible property" used in connection with the production process as storage facilities if they have a useful life of at least four years and are depreciable.

The cement type would also seem to qualify under another portion of the statute, as it is often used as a self-feeder for cattle. A cement trench silo being used in this manner might very well be analogous to a feeding floor, and, thus, be classified as section 38 property because it is "other tangible property" used as an integral part of the production process.

The pertinent problem with the first type of trench silo, the long, narrow hole in the ground, is whether it is depreciable. While land is not ordinarily depreciable, a recent Tax Court decision has held that a hole in the ground is depreciable where there was a showing that the holes were used by a garbage collector as a depository for garbage and that the land would be decidedly lower in value to him when the holes were filled up.[27] By analogy, a trench silo is of much less use to a farmer when its dirt walls have deteriorated to the point that it no longer efficiently preserves silage; thus, it would seem that this type silo should be depreciable and, therefore, eligible for the investment credit.

The 1966 edition of the Farmers Tax Guide, printed and distributed by the Internal Revenue Service, states that "if all other requirements are met," corn cribs, grain storage bins and silos will qualify as section 38 property.[28] Unlike the upright silo and mechanized grain bin, the typical corn crib is not essentially an item of machinery or equipment because it does not have an augering system for use in loading and unloading grain. Therefore, since it is enclosed by walls and covered by a roof, it would seem that a corn crib is within the statutory definition of a buliding. As a building, it would not qualify for section 38 treatment as tangible personal property, as other tangible property used as an integral part of the production process, or as other tangible property used as a storage facility in connection with the production process. Therefore, allowance of an investment credit thereon would be outside of the language of the statute, the regulations interpreting the statute, and Congressional intent. Essentially the same reasoning applies here as was advanced with regard to the non-mechanized grain storage bins.

It was noted in the discussion of non-mechanized grain storage bins that

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26. *Ibid.*
27. Sexton v. Comm'r, 42 T.C. 1094 (1964).
28. U. S. Treas. Dept. Pub. No. 225, FARMER'S TAX GUIDE 13 (1966 ed.).

even though the regulations specifically state that grain storage bins qualify for section 38 treatment, allowing an investment credit thereon is somewhat inconsistent with the statute, the interpretative language of the regulations, and the interpretation which Congress intended the statute to have. It was also pointed out that the type of trench silo which is merely a hole in the ground will not qualify as investment credit property unless it is depreciable, even though the regulations specifically say that a silo does qualify. Therefore, even though the Farmers Tax Guide states that a corn crib is eligible for section 38 treatment, it should not qualify unless it is shown to be the type of property which is embraced within the spirit and purpose of the statute.

Since a corn crib would seem to be analogous to a non-mechanized grain storage bin, it is difficult to reconcile the statement that a corn crib qualifies as section 38 property with the code definition of such property (*i.e.*, a corn crib can only be a building, and thus not the type of property on which an investment credit can be claimed). Therefore, it becomes pertinent to ascertain the source of the statement found in the Farmers Tax Guide, since this may reveal an analogy under which a corn crib would qualify.

It may be that the author(s) of the Farmers Tax Guide felt that a corn crib would qualify because it serves the same purpose as a grain storage bin, and the latter is said to qualify in the regulations. A corn crib may also have been thought to qualify since grain bins, corn cribs, grain elevators, and similar property were all given the same treatment under section 169. Under this section, which is no longer in effect, a taxpayer could amortize the cost of grain storage facilities over a period of sixty months if he intended that they should be used for the storage of grain produced by him.[29] A general type building would not qualify as a grain storage facility, but if a building were suitable primarily for the storage of grain, it was not disqualified for the amortization treatment because it was used for another purpose.[30] Under this statute, a corn crib was entitled to the same treatment as a grain storage bin because it was within the statutory definition of section 169 property.

Both the statute and regulations use the term "storage facilities" when defining section 38 property, just as section 169 allowed amortization on "grain storage facilities." However, the fact that a particular item of property is entitled to specified treatment as a "grain storage facility" under one section of the code does not necessarily require the conclusion that such property is entitled to treatment as a "storage facility" under another section of the code. Rather a determination of whether property qualifies under any section of the code must be made by looking to the definition of the property qualifying for that particular section.

With these factors in mind, can a taxpayer rely on the Farmers Tax Guide and claim an investment credit on a corn crib with any degree of assurance that it is in fact eligible for the investment credit? It is the position of the Internal Revenue Service that this pamphlet is in the nature of an information letter, and,

29. Treas. Reg. § 1.169-2(a)(1) (1958).
30. Treas. Reg. § 1.169-2(b) (1958).

as such, cannot be relied upon by the taxpayer to plan future transactions.[31] The Internal Revenue Service is not bound by any statement in such a letter since it is not a ruling.[32] A recent case affirms this position and states: "nor can any interpretation by taxpayers of the language used in government pamphlets act as an estoppel against the government or change the taxing statutes."[33] A classic example of the type of material published by the government which cannot be relied on is the very pamphlet from which the above information was obtained![34]

If it is assumed for the moment that the taxpayer can rely on the information published in the Farmers Tax Guide, can he accomplish an ultimate tax savings by claiming an investment credit on a corn crib? The answer to this question may well lie in the determination of whether section 1245 or section 1250 will apply to recapture depreciation upon disposition of the corn crib.

Both sections require gain on the disposition of depreciable property to be treated as ordinary income to the extent of the recaptured depreciation. Under section 1250, when one disposes of a building only the prior depreciation computed under accelerated depreciation methods which is in excess of that allowable under the straight line method is considered in computing recaptured depreciation.[35] Further, only a certain percentage of such excess depreciation is recaptured as ordinary income. The applicable percentage subject to recapture is set up on a sliding scale; it is one hundred per cent if the property is disposed of within twenty months after acquisition and decreases one per cent for each month the property is held after twenty months.[36] After the property is held ten years, no depreciation will be recaptured.

On the other hand, under section 1245 *all* prior depreciation is recaptured as ordinary income to the extent that gain occurs on the disposition.[37] Thus it can be seen that recapture under section 1245 will usually result in a substantially greater amount of ordinary income for the taxpayer than results when the recapture is under section 1250.

Generally, section 1250 applies to the disposition of buildings and section 1245 applies to the disposition of all other depreciable property. However, the definition of property covered by section 1245 is essentially identical in substance to that of section 38 property.[38] Thus, it may be that if a farmer claims an investment credit on a corn crib, this corn crib will be subject to recapture of depreciation under section 1245 upon disposition.

The Senate Finance Committee has noted that, although not all section 1245 property will qualify as section 38 property, all property on which an investment credit was, *or* could have been, claimed is subject to recapture of depreciation

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31. Rogovin, *The Four R's: Regulations, Rulings, Reliance, and Retroactivity —Part I,* 42 Strd. Fed. Tax Repts. No. 56, p. 22 (1965).
32. *Id.* at 19.
33. Adler v. Comm'r, 33 F.2d 91 (9th Cir. 1964).
34. *Supra* note 30.
35. I.R.C., § 1250(a)(1).
36. I.R.C., § 1250(a)(2).
37. I.R.C., § 1245(a).
38. Compare I.R.C., §§ 1245 and 48. See Torrey, *Current Problems Involving the Investment Credit,* 17 MAJOR TAX PLANNING 575 (1965).

under section 1245.[39] This language has led one author to conclude that a taxpayer who claims an investment credit on an item of property may be estopped to deny that such property is subject to section 1245 recapture.[40]

Since sections 48 and 1245 property are so closely related, this leaves the attorney with the task of determining whether an investment credit should be claimed on a particular item of property. For example, if a corn crib is within the definition of section 38 property and no investment credit is claimed in the year of acquisition, upon disposition it will still be subject to the recapture of all depreciation claimed since 1961 over and above the adjusted basis. The taxpayer may lose his chance to substantially decrease his total tax liability if he does not discover that his property qualifies for section 38 treatment until the time of disposition. In this situation, there will be no incentive to file an amended return and claim the credit if disposition occurs within four years of the date on which the corn crib is placed in service[41] because the entire credit would be subject to recapture.[42] The statute of limitations should preclude filing an amended return where disposition occurs more than four years after acquisition. However, if the amount of the credit which could have been claimed significantly exceeds the tax due in the year of acquisition, it may be possible to file an amended return in a subsequent year and take advantage of the carryover provisions[43] to the extent of such excess.

If an investment credit is claimed on a corn crib, the literal expression of Congressional intent would seem to require that section 1245 be the operative section upon disposition. Therefore, since the respective amounts which are recaptured under sections 1245 and 1250 are treated as ordinary income, other income received by the taxpayer in the year of disposition will determine whether an ultimate tax savings is accomplished by virtue of the credit. Taxpayers in higher brackets may actually be subject to a greater tax in the long run than they would have been had they not claimed the credit, if claiming the credit does in fact estop them from asserting that the crib is not subject to section 1245 recapture.

As noted above, the Senate Finance Committee report indicates the recapture provisions of section 1245 will apply if an investment credit was claimed.[44] This is probably not a complete statement of the actual Congressional intent. For example, if a farmer claimed an investment credit on a barn, it would not be allowable under the regulations.[45] Thus, the intent of Congress would probably be that such property be subject to recapture of depreciation under section 1245 only if such claim was allowed, or, perhaps, only if such claim was allowable. It is possible that a credit would be allowed, but not allowable (*e.g.*, where the credit was

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39. *Supra* note 24.
40. McAnallen, *The Recapture Rules—§§ 47, 1245, 1250: How They Work, What They Mean, How to Plan*, 21 J. TAXATION 272 (Nov. 1964).
41. The credit must be taken at the time the property is placed in service. Treas. Reg. 1.48-3(d)(4)(i) (1964).
42. I.R.C., § 47.
43. The unused credit can be carried forward for five years. I.R.C., § 46(b)(1).
44. *Supra* note 24.
45. *Supra* note 17.

allowed on a barn). Thus, the Congressional intent does not require the conclusion that a taxpayer is estopped to deny that a barn is subject to the recapture provisions of section 1245 rather than section 1250 as one author has suggested,[46] since a barn is clearly a building and, therefore, subject to recapture of depreciation under section 1250.

CONCLUSION

Property which is depreciable and has a useful life of four years or more will qualify for the investment credit if it is within the definition of any one of the three allowable categories. Thus, the type of section 38 property which the ordinary farmer may own includes tangible personal property, other tangible property used as an integral part of the production process, or other tangible property used as a storage facility in connection with the production process.

Claiming the credit will result in an immediate tax savings, but because of the relationship of sections 48 and 1245, this does not necessarily result in a net tax savings over the long run in all cases. Depreciation on buildings is ordinarily recaptured by section 1250, while depreciation subject to recapture on all other property falls within the provisions of section 1245 upon disposition. Therefore, if an investment credit is allowed or allowable on a "building," it would seem that depreciation thereon will be recaptured by section 1245, rather than section 1250. While the difference in the amount of depreciation which must be recaptured as ordinary income under sections 1245 and 1250 will vary with the holding period and the method of depreciation used, section 1245 will usually recapture a greater amount of depreciation than will section 1250. The tax due on this amount in the year of disposition may approach and even exceed the amount of the investment credit.

If a particular item of property clearly qualifies for the investment credit, one should always claim the credit. Since this property will definitely be subject to recapture of depreciation under section 1245 upon disposition, claiming the credit will result in the maximum tax savings in the long run.

However, if property does not clearly qualify for section 38 treatment and is of the type which may be subject to the recapture provisions of section 1250, several factors may affect the long run tax consequences. Among these are the projected holding period, the method of depreciation used, the income tax bracket in which the depreciation being recaptured will fall, and the amount of the investment credit. If one claiming the credit is in fact estopped to deny that depreciation must be recaptured under section 1245 upon disposition, it is possible that claiming the credit may result in an increased tax liability over the long run. This may be especially harsh where, in the absence of the estoppel factor, the taxpayer could have successfully contended that section 1250 applied upon disposition. With this in mind, it may be desirable to seek a revenue ruling on such items as corn cribs and non-mechanized steel grain bins before claiming the credit if one is to obtain an ultimate long range tax savings.

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46. *Supra* note 40.