

Recaptured depreciation

Depreciable assets often are sold for more than their depreciated value (adjusted tax basis). The amount by which the sale price exceeds the adjusted basis creates recaptured depreciation for the seller, which is subject to income tax. The maximum amount that can be recaptured for depreciable personal property, such as machinery and breeding stock is the total depreciation that has been claimed since the asset was acquired (example 2). Different limits apply for depreciable real property such as buildings.

Gains and losses

The seller may be taxed for a gain on the sale of machinery or breeding livestock. This occurs when the selling price is more than the original tax basis of the asset plus the cost of any improvements. The difference between the two figures is a long-term capital gain (example 3). Capital gains are subject to federal income taxes at a maximum rate of 15 percent, and are subject to state income taxes, but they are not taxed as self-employment income.

Example 3. Computing depreciation recapture and capital gain.

| | |
|---------------------------|------------------|
| Sale price | \$60,000 |
| Original purchase price | \$50,000 |
| Depreciation taken | <u>-\$20,000</u> |
| Depreciation to recapture | \$30,000 |
| Sale price | \$60,000 |
| Original purchase price | <u>-\$50,000</u> |
| Capital gain | \$10,000 |
| Purchaser's tax basis | \$60,000 |

Sizable capital gains often occur when machinery is acquired through several successive trades, resulting in a very low basis, or when very young breeding livestock is acquired. Breeding livestock must be held at least 12 months or more (24 months or more for cattle and horses) to qualify for capital gains treatment. Breeding livestock that was produced and raised on the farm has a beginning tax basis of zero. A loss can occur if the selling price is below the adjusted tax basis of the asset (example 4). Individu-

Example 4. Computing loss.

| | |
|-----------------------|------------------|
| Sale price | \$10,000 |
| Depreciated value | \$20,000 |
| Sale price | <u>-\$10,000</u> |
| Loss | \$10,000 |
| Purchaser's tax basis | \$10,000 |

als can use such capital losses to offset capital gains plus up to \$3,000 of ordinary income each year. Corporations can use them only to offset capital gains.

When an asset is transferred as a gift, no depreciation recapture, gain, or loss occurs. However, the recipient of the gift must use the giver's last adjusted tax basis as his/her beginning basis if the fair market value equals or exceeds the basis. If the fair market value at the time of the gift is less than the basis, the fair market value becomes the beginning basis for the recipient.

Interest and principal

Interest on business obligations paid by the buyer to a lender or to the seller is normally tax deductible as an ordinary expense. Interest received by the seller, such as in an installment sale, is taxable income but is not subject to self-employment tax.

Principal payments made by a buyer to repay a loan or to make installment payments to a seller are not tax deductible. Principal payments are made from "after-tax" income.

Principal payments received by the seller can be considered as recaptured depreciation, capital or ordinary losses, or capital gains, as explained earlier.

Lease payments

Rent paid for the use of farm assets under a bona fide lease also is an ordinary expense to the renter and taxable income to the owner. Rent paid under a lease that closely resembles a purchase agreement is not deductible. Instead, the purchaser may continue to claim a deduction for depreciation as well as for interest, repairs, taxes, and insurance.

In recent years, income from the rental of personal property, such as machinery or livestock, has been subject to self-employment tax if the property is not rented in connection with real estate. The IRS may be adopting the position that such rentals are subject to self-employment tax only if the rental activities of the owner amount to a business. So rent received for the use of livestock and machinery may be excluded from self-employment income if the owner is a non-material participant, and the rental of these assets is tied closely to the rental of real estate. For a two-generation situation in which the parents have not completely retired, non-participation may be difficult to show, however.

Before entering into any agreement to sell or rent farm assets, both parties should consult a knowledgeable tax practitioner to determine the income tax consequences for a specific action.

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