Ag Decision Maker

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Income Tax Considerations of Business Transfers

Whether you are transferring the ownership of machinery (*Information File A3-32*, Transferring Ownership of Farm Machinery, www.extension.iastate.edu/agdm/crops/pdf/a3-32.pdf), breeding livestock (*Information File C4-83*, Transferring Breeding Livestock, www.extension.iastate.edu/agdm/wholefarm/pdf/c4-83.pdf) or market livestock and crops (*Information File C4-84*, Transferring Crops and Market Livestock, www.extension.iastate.edu/agdm/wholefarm/pdf/c4-84.pdf), both buyer and seller need to be familiar with income tax provisions concerning the transfer of depreciable assets.

Depreciation

The buyer of farm assets can claim regular depreciation as a tax deduction beginning in the tax year in which he/she places the property in service. The Internal Revenue Service (IRS) allows several options for calculating depreciation.

One common method is the MACRS 150 percent declining balance option. Example 1 shows how a piece of machinery with an initial tax basis of $60,000 is depreciated over eight income tax years. The initial basis is equal to the purchase cost of the machine, or the cash difference (boot) paid on a trade plus any remaining undepreciated balance on the trade-in. The adjusted basis is equal to the initial basis minus the total amount of depreciation expense claimed so far.

In some cases the buyer also can claim expense method depreciation (section 179). With this option, the IRS allows up to a maximum amount, currently $500,000, of the eligible cost of an asset to be deducted in the year of purchase. Smaller amounts are allowed. The remaining basis of the asset then is depreciated by one of the other methods. One expense method deduction is allowed for each tax return each year. However, this option is not available for acquisitions from closely-related parties, which can affect many family transactions.

Example 1. Depreciating a machinery by the MACRS 150% declining balance option[1]

Original Basis = $60,000

Tax Year	Tax depreciation (adjusted) tax	Year-end (adjusted) Depreciation	Tax Basis
1	10.71%	$6,425	$53,574
2	19.13	11,478	42,096
3	15.03	9,018	33,078
4	12.25	7,350	25,728
5	12.25	7,350	18,378
6	12.25	7,350	11,028
7	12.25	7,350	3,678
8	6.13	3,678	0

[1] *See Chapter 8. Farmer's Tax Guide, for more details.*

Example 2. Computing depreciation recapture on a sale

Sale price	$40,000
Original purchase price	$50,000
Depreciation taken	-$30,000
Depreciated value (adjusted basis)	$20,000
Sale price	$40,000
Depreciated value	-$20,000
Depreciation to recapture	$20,000
Purchaser's tax basis	$40,000

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The maximum expense method depreciation amount can change from year to year.

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 varying rates, 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	-$30,000
Depreciated value (adjusted basis)	$20,000
Sale price	$60,000
Original purchase price	-$50,000
Capital gain	$10,000
Depreciation to recapture	$30,000
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). Individuals 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.

Example 4 . Computing loss

Sale price	$10,000
Depreciated value	$20,000
Sale price	-$10,000
Loss	$10,000
Purchaser's tax basis	$10,000

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 genuine 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.