Income Tax Considerations When Transferring Depreciable Farm Assets

Ag Decision Maker
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File C4-81

Whether you are transferring the ownership of machinery, breeding livestock, or market livestock and crops, 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 a person places the property in service. The Internal Revenue Service (IRS) allows several options for calculating depreciation. See Table 1 for examples.

Table 1. Common depreciation classes for some farm assets

Class	Description
3-year	Breeding swine
5-year	Vehicles, breeding/dairy cattle, new machinery
7-year	Used machinery, grain bins, fences, silos
10-year	Single-purpose agricultural structures
20-year	Other farm buildings

For a more complete listing, see IRS publication 225, Farmer's Tax Guide.

One common method of depreciation is the five-year Modified Accelerated Cost Recovery System (MACRS) 200 percent declining balance option, which is allowed for new machinery. Example 1 shows how an item of machinery with an initial tax basis of $60,000 is depreciated over six income tax years. Because only a half year of depreciation is allowed in the first and last years, it takes six tax years to fully depreciate a five-year life asset. The initial basis is equal to the purchase cost of the machine. The adjusted basis is equal to the initial basis minus the total amount of depreciation expense claimed so far. Alternatively, a 150% declining balance method can be elected.

In some cases the buyer also can claim **expense method depreciation** (Section 179). With this option, the IRS allows up to a maximum amount of the eligible cost of an asset to be deducted in the year of purchase. Smaller amounts are also allowed. The remaining basis of the asset then is depreciated by one of the other applicable 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 item by the MACRS 200% declining balance option[1]

Original Basis = $60,000

Tax year	Depreciation rate	Depreciation	Adjusted tax basis
1	20.00%	$12,000	$48,000
2	32.00	19,200	28,800
3	19.20	11,520	17,280
4	11.52	6,912	10,368
5	11.52	6,912	3,456
6	5.76	3,456	0

[1] See Chapter 8, IRS Publication 225, Farmer's Tax Guide, for more details.

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 ordinary income tax, but not self-employment tax. The maximum amount that can be recaptured for depreciable

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personal property, such as machinery and breeding livestock 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.

Example 2. Computing depreciation recapture on a sale

Sale price	$40,000
Original purchase price (basis)	$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

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 made. 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, usually lower than ordinary income tax rates, but they are not taxed as self-employment income.

Sizable capital gains often occur when breeding livestock acquired at a young age is sold after reaching maturity. Breeding livestock must be held at least 12 months or more (24 months or more for cattle and horses) and have been used or intended to be used for breeding or dairy purposes to qualify for capital gains treatment. Breeding livestock that was produced and raised on the farm itself has a beginning tax basis of zero.

Example 3. Computing depreciation recapture and capital gain on a sale

Sale price	$60,000
Original purchase price (basis)	$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

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 a capital loss

Sale price	$10,000
Depreciated value (adjusted basis)	$20,000
Sale price	-$10,000
Capital 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 their 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 a contract 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 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, however. Instead, the renter is considered to be the purchaser and may 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.

More Information

Ag Decision Maker, Transition and Estate Planning, www.extension.iastate.edu/agdm/wdbusiness.html

Information File A3-32, Transferring Ownership of Farm Machinery, www.extension.iastate.edu/agdm/crops/pdf/a3-32.pdf

Information File C4-83, Transferring Breeding Livestock, www.extension.iastate.edu/agdm/wholefarm/pdf/c4-83.pdf

Information File C4-84, Transferring Crops and Market Livestock, www.extension.iastate.edu/agdm/wholefarm/pdf/c4-84.pdf

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