Farm Management

Transfer of machinery to next-gen

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WHEN farmers begin to consider retiring, the machinery is oftentimes the asset they wish to transfer first. Machinery generally requires more maintenance and creates more liability than other farm assets. Regardless of how it's done, transferring machinery has major tax implications. Here are some strategies to consider for transferring machinery.

A retiring farmer can simply gift his machinery to the next generation. Gifts up to $14,000 are allowed annually. An amount greater than $14,000 reduces the giver's estate tax exemption. The primary tax issue with gifting involves the tax basis. When an asset is gifted, the person receiving the gift (giftee) takes the tax basis of the donor. That is, the giftee does not get a stepped-up tax basis.

Say, Father owns $500,000 of machinery. He has aggressively depreciated (Section 179) it all to offset income the last few years and has $50,000 in depreciation remaining (tax basis). He gifts the machinery to Son. Son now owns the machinery, but can only depreciate the remaining $50,000 tax basis, not the entire $500,000.

But if Son inherits the machinery, he receives the machinery with a stepped-up basis. Using the above example, Father instead passes away and Son inherits the machinery. Son now owns the machinery with a $500,000 tax basis, which he can depreciate. Son has an extra $450,000 of depreciation that he can use to offset income.

The challenge is timing. Father wants to transfer machinery soon to rid him of maintenance and liability. But don't transfer machinery before an imminent death. Some have made the mistake of transferring machinery shortly before their death to make estate administration easier for their heir. However, the stepped-up basis received by the heir is likely worth considerably more than the costs of estate administration.

Farmers are often surprised when confronted with the tax liability of selling machinery. When sold, most machinery has little or no tax basis, causing the sale proceeds to be classified as depreciation recapture. This results in the entire sale proceeds being subject to ordinary income tax rather than capital gains. Also, sales generating significant revenue can push the seller into higher tax brackets. It is not uncommon for the tax liability to be 40% or more on machinery sales.

Installment sales of machinery do not ease taxes much. All of the depreciation recapture is due in the first year of the sale. Even if machinery is sold with payments being made over 10 years, most, if not all, of the taxes are still due the first year.

Leasing

Another strategy is to lease the equipment with an option to sell at the end of