Transferring Farm Machinery to the Next Generation

Robert Moore
Wright Law Co. LPA
Dublin, OH
614-791-9112
rmoore@wright-law.net

While many farmers never truly retire, they often reach a point that they would like to slow down and turn ownership over to the next generation. Family farms often find it challenging to make this transition because the retiring generation often needs retirement income from their assets but requiring the next generation to purchase those assets can often cause financial stress for the farm. In particular, the farm machinery presents an especially difficult challenge.

The sale of farm machinery will likely cause significant tax liability for the retiring farmer. The machinery has likely been depreciated to the point that it has very little or no tax basis. Therefore, the retiring farmer will pay ordinary income on all of the depreciation recapture. For example, Farmer sells his machinery inventory for $500,000 and the machinery has a $50,000 tax basis. Farmer will have $450,000 in ordinary income to report. This high income level will likely push Farmer into a higher tax bracket of 35%. The federal tax on this sale alone would be somewhere around $135,000.

Further exacerbating the issue, all the tax from the sale is due the year of the sale. Therefore, even if the machinery is sold as an installment sale to the next generation, the retiring farmer pays all the tax in the first year of the installment sale. So, while installment sales help reduce the financial stress on the farm, it does nothing to help with tax liability for the retiring farmer.

A strategy that some producers use to help manage the tax liability on machinery sales is a lease arrangement. The retiring farmer will lease the machinery to the next generation at a fair rate. The lease may be for several years and at the end of the lease, the next generation purchases the machinery. The retiring farmer will still pay income tax on the lease payments and final buy out payment as well as self-employment tax, but the income tax liability is spread over several years keeping the retiring farmer in a lower tax bracket. The purchasing farmer gets to deduct the lease payment as an expense. It is very important to structure the lease so that it is not actually a disguised installment sale. The IRS has established four tests to qualify for a lease, see your tax professional to discuss whether your agreement meets these tests.

LLC's can be used to facilitate the transfer of machinery to the next generation. The retiring farmer places the machinery in an LLC and then sells his/her ownership in the LLC over time. This strategy essentially allows for an installment sale without triggering all the tax liability up front. However, machinery that has debt exceeding basis should not be put into an LLC as the transfer will trigger a taxable event to the owner. Also, if any machinery is sold within seven years, all the gain on the sale is attributed back to the

retiring farmer. Furthermore, the buyer is buying ownership in an LLC and not tangible assets. Therefore, the buyer cannot take depreciation on his/her purchases. This strategy is likely the easiest to administer but will likely have the least favorable tax liability.

Another strategy is for the next generation farmer to purchase a few pieces of equipment each year. This allows the retiring farmer to spread his/her tax liability over several years. This strategy works best when the purchaser and seller analyze their financial positions at the end of the year. If the seller needs income or has expenses to offset the income from the sale, he/she should sell equipment. If the purchaser has funds to purchase then purchases should be made. The two parties need to assess each other's needs to finds a suitable sale/purchase for both. This process can be done each year, machinery sales do not need to be the same every year.

Lastly, another issue in this process is §179 depreciation. When a purchase is made from a related party, the purchaser may not use §179 depreciation. Additionally, §179 depreciation cannot be taken when the buyer had previous use of the equipment, such as in the lease arrangement discussed above. Therefore, the next generation purchaser must either use straight line or Modified Accelerated Cost Recovery System (MACRS) depreciation. This causes the depreciation to be spread over seven years instead of being able to be taken immediately. The purchaser will therefore have less flexibility and options in managing tax liability for the farm.