Transferring Ownership of Farm Machinery

Ag Decision Maker

File A3-32

Farm machinery is an important component of transferring ownership (Information File Business Ownership Transfer Process) from the older party to the younger party. The use and ownership of farm machinery can be transferred from the older party (seller or giver) to the younger party (buyer or recipient) immediately or over several years.

Five basic transfer methods are available:

- outright sale,
- installment sale,
- gradual sale over a period of years,
- lease agreement followed by a sale, and
- gift.

Each method has different financial and income tax consequences.

The methods of transferring machinery ownership outlined in this section are illustrated by using examples. These examples are based on the four machines listed in Example 1 with a total current market value of $264,000 and income tax basis of $102,916.

In all cases, a value must be placed on each piece of equipment at the time it will be transferred. A machinery dealer or auctioneer may be willing to make an appraisal for a fee. List each item as it appears on the seller's depreciation schedule and the value that is agreed upon.

Outright Sale

An outright sale occurs when the seller of machinery transfers ownership to the buyer immediately and is paid the full purchase price by the buyer.

An outright sale gives the buyer complete freedom to use, sell, trade, or lease the machinery, or use it as collateral for securing a loan. The seller has no further claim to the machinery and can spend or invest the funds received as desired.

Financial considerations

For an outright sale, the buyer's payment is equal to the full agreed-on value of the machinery. A beginning farmer may find it difficult to generate this much cash from savings and equity. A third party lender may be willing to provide a loan if the machinery can serve as collateral or if the buyer has other assets to pledge. Beginning farmers with a small net worth may need a co-signer for a loan. In family situations, the co-signer may be the seller of the machinery.

When the younger party doesn't want to use all savings for purchasing machinery, or doesn't want to go into debt, other methods that reduce the initial financial obligation can be used.

Income tax considerations

The income tax consequences of an outright sale can be substantial, as shown in Example

Example 1. Inventory of machinery.

Description	Current Market (sale value)	Original Tax Basis	Last Adjusted Tax Basis
Tractor no. 1	$70,000	$120,000	$51,456
Tractor no. 2	$40,000	$70,000	0
Planter	$24,000	$40,000	$ 2,452
Combine	$130,000	$160,000	$49,008
	$264,000	$390,000	$102,916

PM 1450 Revised August 2013

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2. For the seller, a large amount of recaptured depreciation and capital gain may arise from the sale, especially if some assets have an adjusted tax basis of zero; that is, they are "depreciated out." Reporting all the income and gain in one tax year may cause some of it to be taxed at a higher marginal rate than the seller usually pays. In addition, most sellers prefer to spread out or postpone tax payments whenever possible.

The buyer can begin depreciating the machinery in the year it is placed in service and may use the expense method depreciation allowance, if eligible. Buyers who are relatively new in farming may not have enough taxable farm income to make use of the maximum expense method depreciation allowance, however.

Installment Sale

An installment sale gives the buyer immediate possession and use of the machinery, just as in an outright sale. However, the seller finances the sale for the purchaser, and periodic payments are made, as shown in Example 3.

Example 2. Machinery outright sale.

Seller

Sale price (Ex. 1):	$264,000
Recaptured depreciation (Ex. 1):	$161,084 (264,000 - 102,916)
Capital gain [1]:	$ 0

Buyer

Beginning basis:	$264,000
Depreciation in first year:	
nonfamily sale [2]	
-- expensing:	$ 38,000
-- MACRS:	$ 24,205 [(264,000 - 38,000) x .1071]
family sale	
-- expensing	$ 0
-- MACRS:	$ 28,274 (264,000 x .1071)

[1] There is no capital gain because the sale price of each machine is below the original tax basis.

[2] Depreciation includes section 179 expensing of $38,000 (a larger amount could have been deducted) plus seven-year class MACRS depreciation using the 150% declining balance method.

Example 3. Machinery installment sale.

Sale price:	$264,000
Term:	Four annual payments
Interest:	6% on the unpaid balance
Down payment:	none

Payment schedule:

Year	Principal	Interest	Total	Unpaid balance
Now	------	------	------	$264,000
1	$66,000	$15,840	$81,840	198,000
2	66,000	11,880	77,880	132,000
3	66,000	7,920	73,920	66,000
4	66,000	3,960	69,960	0

Income tax consequences are the same as in Example 2.

Financial considerations

An installment sale can ease the cash flow requirements for a beginning farmer by spreading payments over several years. Compared with the terms of a commercial loan, an installment sale may have a longer repayment term, lower interest rate, and/or a smaller down payment.

The seller, however, does not have the benefit of receiving payment as quickly as with an outright sale. In addition, the machinery may depreciate faster than the debt is repaid, causing the collateral value to be less than the outstanding debt.

In an installment sale, the amount and timing of the payments can be scheduled to match the income stream generated by the assets. For example, the payment for purchasing a line of machinery may come once a year when the crops are sold.

The payment schedule also should specify the rate of interest to be paid on the unpaid balance. This rate can be fixed for the life of the contract or renegotiated periodically. Family agreements sometimes contain below market interest rates. If the interest rate is lower than the "applicable federal rate," the payments must be recalculated at the federal rate when reporting interest for income taxes. The applicable federal rate is adjusted monthly and can be obtained from most tax preparers or the Internal Revenue Service (IRS).

Income tax considerations

For the buyer, the tax consequences of an installment sale are the same as for an outright purchase. The assets are immediately transferred to the buyer's depreciation schedule. In addition, interest paid becomes a deductible expense.

The seller must report all recaptured depreciation in the year of sale, even if payments are spread over more than one tax year. When the buyer and seller are closely related, all capital gains (if any) also may be taxable in the year of sale. This applies to parents, children, spouses, and certain corporations, partnerships, and trusts. Check with a qualified tax preparer to determine what rules apply to your particular situation. For unrelated parties, capital gain is taxed in the years that debt payments are made, but recaptured depreciation is still taxed in the year of sale.

When several pieces of machinery are sold together, the selling price is allocated among them based on their relative fair market values. Likewise, the buyer allocates the purchase price among the items based on relative fair market values to obtain the beginning basis for depreciation.

Interest is taxed as it is received. Thus, the taxation of the payments of a sale between related parties can be spread out somewhat by increasing the interest rate and lowering the purchase price of the machinery within a reasonable margin.

Gradual Sale

A line of machinery also can be transferred

Example 4. Machinery gradual sale.

	Year 1	Year 2	Year 3	Year 4
Item sold (Ex. 1):	tractor no. 2	planter	tractor no. 1	combine
Seller				
Sale price: [1]	$40,000	$22,000	$56,000	$90,000
Adjusted basis: [2]	0	0	$22,056	0
Recaptured depreciation:	$40,000	$22,000	$33,944	$90,000
Buyer				
Beginning basis:	$40,000	$22,000	$56,000	$90,000
Depreciation in first year:				
-- nonfamily sale: [3]	$38,214	$22,000	$39,928	$43,570
-- family sale: [4]	$ 4,284	$ 2,356	$ 5,998	$ 9,640

[1] Sale prices are decreased in later years to reflect wear and obsolescence.

[2] The adjusted basis is decreased in later years to reflect the additional tax depreciation claimed.

[3] Depreciation includes section 179 expensing at the $38,000 level (more could have been taken), plus MACRS depreciation using the 150% declining balance method.

[4] Depreciation is based on the MACRS 150% declining balance method. No section 179 expensing is allowed.

by selling one or two items outright each year as shown in Example 4. Such a gradual sale can spread out tax payments as well as the cash flow requirements. The assets transferred each year must be clearly specified. The buyer becomes responsible for repairs, insurance, and other ownership costs when each piece of machinery changes hands.

A plan should be developed identifying which items of machinery will be transferred each year and how many years will be required to complete the transfer. A gradual sale can continue until all the machinery is sold.

If the parties farm together, the gradual transfer may change how farm income is divided each year. The younger party will own more of the business assets each year so should receive a larger share of the income. If the older party has already left the business, the younger party will need to lease items that have not yet been purchased.

Financial considerations

With a gradual sale, the cash flow requirements are spread over a period of years, similar to an installment sale or an outright sale financed by a lender. However, the gradual sale does not require the buyer to borrow money to buy the entire machinery line.

Another advantage of a gradual machinery sale is that the number of items transferred can be adjusted each year to fit the buyer's cash flow situation. For example, if the younger party has a low profit year, the number of items purchased that year can be reduced or eliminated. Conversely, the number of items can be increased in a year of high profits.

Some sellers elect to transfer ownership each time a major equipment item is replaced. The buyer can supply the down payment money for the trade and pay the seller the fair market value of the item traded. If co-ownership is desired, the fair market value of the item traded is counted toward the seller's portion of the cost of the new machine.

Income tax considerations

The tax consequences of a gradual sale are the same as those described for the outright sale, but occur over several years. Unlike an installment sale, a gradual sale spreads both recaptured depreciation and capital gains over a period of years. It also allows an eligible buyer to use the expense method depreciation option each year.

In addition, selling machines with the highest adjusted tax basis last allows the seller to continue to depreciate them.

Leasing

A lease can be used in situations where the owner (older party) already has left the business. For example, if the older party leaves the business before the machinery ownership is transferred, the machinery can be leased until it is purchased.

The lease payments should be reasonable and should cover the owner's fixed costs of depreciation, return on investment, and insurance. Tax depreciation is usually a poor estimate of actual economic depreciation. Economic depreciation can be estimated by multiplying the current market value of the machinery by 8 to 10 percent. Return on investment can be computed by multiplying the current market value by a return of 6 to 8 percent. The actual cost of insurance can be used. Alternatively, the lease payment can be computed by multiplying the current market value by 15 to 20 percent.

The renter (younger party) is usually responsible for all costs related to use, such as fuel, lubrication, repairs, and maintenance. The owner (older party) is usually responsible for paying for capital improvements, such as major overhauls or the replacement of an engine. These improvements increase the value of the machine, the rental rate, and the eventual sale value. Rental payments should decrease as the machinery line ages, unless older machines are replaced.

When a machine is used by both the owner and the renter, an agreement (Information File Machinery and Labor Sharing Agreement) can be created and lease payments can be calculated by the acre or by the hour. A lease arrangement often is combined with one of the methods of transferring ownership described previously.

Lease with Option to Buy

Leasing machinery with an option to buy allows the younger party to use the equipment for a period of years and then buy it at the end of the lease period.

Financial considerations
Leasing a machine from the older party can lower the cash flow requirements of the younger party in the early years, as illustrated in Example 5. It also allows the buyer to accumulate financial resources and to be more certain about what direction the farming operation will take before purchasing.

Income tax considerations
Lease payments are taxed as they are received by the owner (older party) and are a deductible expense to the renter (younger party). All leased machinery remains on the depreciation schedule of the owner. If the option to purchase is exercised, the same tax consequences arise as described for an outright sale, but they are based on the sale price at the time the option is exercised.

To be taxed as a true lease agreement, a lease with an option to buy arrangement must allow for the purchase at the end of the lease to be optional, and the eventual purchase price must be near the fair market value of the machinery at that time. Lease payments must reasonably reflect the value of the machinery. If the lease does not meet IRS conditions for a lease, it will be taxed as an installment sale.

Lease with Gradual Sale

A lease can be combined with a gradual sale in situations where the owner (older party) leaves the business before the sale is completed. Each year, the buyer (younger party) purchases one or more items of machinery

Example 5. Machinery lease with option to buy after three years.

	Year 1	Year 2	Year 3	Year 4
Value [1]	$264,000	$238,000	$214,000	$192,000
Lease payment [2]	$ 39,600	$ 35,700	$ 32,100	
Purchase				$192,000
Seller				
Sale price in fourth year:	$192,000	(fair market value)		
Adjusted tax basis:	0			
Recaptured depreciation:	$192,000	(after year 4)		
Buyer				
Beginning basis:	$192,000			
Depreciation in first year of ownership:				
nonfamily sale: [3]				
-- expensing	$ 38,000			
-- MACRS:	$ 16,494	[(192,000 - 38,000) x .1071]		
family sale				
-- expensing	$0			
-- MACRS:	$ 20,564	(192,000 x .1071)		

[1] Current value is reduced to reflect economic depreciation.
[2] Computed at 15% of current value.
[3] Depreciation includes section 179 expensing at $38,000, plus MACRS depreciation using the 150% declining balance method.

Example 6. Machinery gradual sale/lease combination.

	Year 1	Year 2	Year 3	Year 4
Item sold (Ex. 1):	tractor no. 2	planter	tractor no. 1	combine
Sale price:	$40,000	$22,000	$56,000	$90,000
Value of remaining machinery:	$194,000	$152,000	$90,000	0
Lease payment (15%):	$29,100	$22,800	$13,500	0
Total payment (lease plus sale):	$69,100	$44,800	$69,500	$90,000

Recaptured depreciation and depreciation in first year are the same as for Example 4.

and leases the machinery that has not yet been purchased. As items are purchased, they are dropped from the lease arrangement and the lease payments are reduced accordingly. Example 6 shows an example of a combined lease and gradual sale.

Gifting

Machinery also can be transferred from the older party to the younger party as an outright gift.

Financial considerations

With a gift, the giver (older party) receives no payment from the recipient (younger party) in exchange for the machinery. Although a gift program is financially advantageous for the recipient (younger party), it may be a burden to the giver (older party) if money is needed for living expenses and other commitments. Also, in a parent and child situation, other family members may feel that they have not been treated fairly unless gifts of an equal value are made to them as well.

Income tax considerations

The adjusted income tax basis of machinery transferred as a gift generally carries over to the recipient's depreciation schedule as shown in Example 7. Gifting has the advantage of delaying the income tax consequences of the transfer until a later time. However, the recipient (younger party) will have few or no depreciation deductions from items with a low adjusted basis, such as older machinery.

Gift tax considerations

Federal tax laws allow gifts of present interests of up to $14,000 (2013) annually to be excluded from gift tax (AgDM File C4-23 Gift Tax). The exclusion is annual so it can be used every year (the gift tax exclusion amount may be adjusted each year). Up to $28,000 can be given by a wife and husband, even if only one of them owns the property. When gifts are made to both the gift recipient (younger party) and his/her spouse, the amount is doubled. So, the older party husband and wife can give up to $56,000 to the younger party husband and wife without being subject to gift tax fil-

Example 7. Machinery outright gift.

<u>Seller</u>	
Fair market value:	$264,000
Sale price:	0
Adjusted basis:	$102,916
Depreciation recapture:	0
Capital gain:	0
Gift:[1]	$264,000
<u>Buyer</u>	
Purchase price:	0
Beginning basis:	$102,916

[1] May reduce the unified credit and could be subject to gift tax.

ing. Taxable gifts beyond this exclusion are included in the calculation of federal estate tax (Information File Federal Estate Tax) after death and may increase the amount of federal estate tax due.

Combination Sale and Gift

Machinery gifts can be combined with an outright sale. The difference between the fair market value of the machinery and the amount of cash paid for the machine is considered a gift. These values should be documented carefully. If the size of the gift is equal to or less than the annual exclusion, no gift tax filing is due.

Financial considerations

The combination sale and gift method reduces the buyer's (younger party's) cash flow requirements. However, the seller (older party) receives less money to spend or invest, which could reduce financial security during retirement.

Income tax considerations

The tax consequences of a combination sale and gift are shown in Example 8. The lower sale price reduces the amount of recaptured depreciation and could lower or eliminate capital gains. However, the buyer (younger party) will have a lower initial tax basis to depreciate when the machinery is purchased.

Gradual Gift and Sale

Combining a gradual sale with a gifting program is similar to a gradual sale except that the sale price of each item is below fair market value. The difference is considered a gift. An advantage of this method is that the annual gift tax exclusion can be used every year.

Example 8. Machinery combination sale and gift.

Seller		
Fair market value:	$264,000	
Sale price:	$200,000	
Adjusted basis:	$102,916	
Depreciation recapture:	$ 97,084	(200,000 - $102,916)
Gift: [1]	$ 64,000	(264,000 - $200,000)
Buyer		
Purchase price:	$200,000	
Beginning basis:	$200,000	
Depreciation in first year:		
nonfamily sale [2]		
-- expensing:	$ 38,000	
-- MACRS:	$ 17,350	[(200,000 - 38,000) x .1071]
family sale		
-- expensing:	$ 0	
-- MACRS:	$ 21,420	(200,000 x .1071)

[1] May reduce the unified credit and could be subject to gift tax.

[2] Depreciation includes section 179 expensing at $38,000, plus MACRS depreciation using the 150% declining balance method.

Financial considerations

In addition to spreading the purchase cost over several years, it also reduces the size of the payment each year. However, the seller (older party) receives less cash, which may negatively impact his/her financial position during retirement.

Some gradual sale and gift agreements specify that when a machinery item is replaced, the item to be traded is gifted to the younger party who then supplies the cash difference needed to complete the trade.

Example 9. Machinery gradual combination sale and gift.				
	Year 1	Year 2	Year 3	Year 4
Item sold (Ex. 1):	tractor no. 2	planter	tractor no. 1	combine
Seller				
Market value: [1]	$40,000	$22,000	$56,000	$90,000
Sale price: [1]	$24,000	$12,000	$36,000	$50,000
Adjusted basis: [2]	0	0	$22,056	0
Depreciation recapture:	$24,000	$12,000	$13,944	$50,000
Gift: [3]	$16,000	$10,000	$20,000	$40,000
Buyer				
Purchase price:	$24,000	$ 12,000	$36,000	$50,000
Depreciation in first year:				
-- nonfamily sale: [4]	$24,000	$ 12,000	$36,000	$39,286
-- family sale:	$ 2,570	$ 1,286	$ 3,856	$ 5,356

[1] Market values are reduced in later years to reflect wear and obsolescence.

[2] Adjusted basis is decreased in later years to reflect the additional tax depreciation claimed.

[3] Equal to market value minus sale price. May reduce the unified credit and be subject to gift tax.

[4] Depreciation includes section 179 at $38,000, plus MACRS depreciation using the 150% declining balance method.

Income tax considerations

The income tax consequences of this method are shown in Example 9. The value of the gift reduces the sale price of each machine, which reduces the amount of recaptured depreciation. However, the initial basis and amount of depreciation that can be claimed by the buyer also is reduced.

Issued in furtherance of Cooperative Extension work, Acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture. Cathann A. Kress, director, Cooperative Extension Service, Iowa State University of Science and Technology, Ames, Iowa.

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