AGRICULTURE SERVICES

CONSIDERING TRADING YOUR EQUIPMENT ON A LEASE?

UNDERSTANDING THE TAX RULES, RISKS AND REWARDS WILL HELP WITH SMART LEASING.

The art of tax planning can be tricky – especially when it comes to the minutia of business decisions, like trading in your equipment on a lease – but the proper arrangement can make a huge difference and put more money in your pocket in the long term, especially if you're considering doing so right now. With low prices for corn, soybeans and wheat, equipment companies and banks are expanding operating leases to farmers. Equipment dealers offer lease deals to move equipment inventory which fits within the tight cash flow needs of producers. In many cases, farmers will use the trade-in value on their equipment as a down payment on the lease. Depending upon the type of lease, there can be unintended tax consequences. Producers need to understand the tax rules for the various types of lease contracts offered.

CHOOSING AN 'OPERATING' LEASE VS. A 'CAPITAL' LEASE

An 'operating' lease is often what people think of when renting equipment. A cash basis farmer will make payments for a period of time to use the equipment and then returns the equipment at the end of the lease, or, purchase it for fair market value. The cash basis farmer deducts these lease payments on their tax return over the term of the lease. However, there are additional income tax implications to consider when structuring the terms of the lease. Often times, the farmer trades owned equipment and applies the trade in value to the lease. In this situation, tax law directs us to treat the trade-in value of the old equipment as a sale, and subject to income tax.

TO ILLUSTRATE:

Assume you have a combine that is fully depreciated (using Section 179 previously) and the trade in value is $125,000. The trade-in value is considered a sale and you must recognize a gain of $125,000 in the year in which you enter the lease agreement. The benefit of an operating lease is that farmers can deduct the lease payments over the life of the lease. The trade-in value that is used for the down payment is amortized over the life of the lease and is deductible as well. In the above example, if the lease term was over four years, the deductible amount of the down payment would be $31,250 each year.

TRADE-IN VALUE

$125,000

LEASE AGREEMENT

AMORTIZATION

YEAR ONE	YEAR TWO	YEAR THREE	YEAR FOUR
$31,250	$31,250	$31,250	$31,250

Equipment dealers also offer 'capital' lease agreements. These are essentially financing arrangements versus an operating lease. These kind of leases can be structured where part of the lease payment is applied to an equity position in the newly acquired equipment. In this arrangement, the equipment title transfers after all lease payments are made, or, the sum of the payments exceed the current fair market value, or, the equipment is purchased at the end of the lease for a bargain purchase price compared the actual value at the end of the lease. If the lease has any of these terms, then it probably is not an operating lease.

Tax law treats these types of arrangements as a purchase of equipment and any trade-in value becomes eligible for like-kind exchange treatment. Because this is a purchase, the farmer would need to follow all the rules for depreciating that equipment and would not deduct any lease payments as we would in an operating lease. Also, because this is considered a financing arrangement, a portion of the payments would be considered interest expense and deductible as a farm expense.

For more information about our services, visit www.sikich.com/tax-services.

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WE CAN HELP!

Leases can have their place in your farm business plan, especially if cash flow is tight and the interest rate is similar to traditional bank financing. Leased equipment can also fit as a tax planning tool. Prior to entering into a lease agreement, consult with a Sikich advisor to review and understand how it fits into your tax plan.

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