

Transferring Machinery and Livestock

Agricultural Business Management

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Introduction:

At retirement, most farmers are faced with how to best dispose of their assets. The easiest assets to dispose of are the crops on hand and market livestock. They can simply be hauled to market and sold. The major concern here involves the issue of self-employment tax and income taxes.

Income Taxes:

For the farmer using cash basis accounting, income tax is due and payable immediately on any proceeds from the sale of crops and market livestock. Selling everything in one year can push you into a higher tax bracket. Spreading the income over a few years may provide some tax management. You might also use a deferred payment contract to spread income into future years.

Self-Employment (SE) Tax:

Self-employment (SE) taxes must also be paid when crops or market livestock are sold. Note, a new federal Medicare Surtax on some active and passive income and the sale of assets over certain thresholds has been established. For farmers there are exceptions so consult with your accountant and attorney before making the sales.

You may want to consider the following:

- Selling everything in one year may lessen your overall SE tax. The Social Security (SS) portion of the SE tax is adjusted for inflation each year and the income subject to this tax is capped. Bunching all SE income into one year to greatly exceed the threshold may result in less tax paid than if you spread out SE income over several years and paid SE tax on all of it. **Caution:** Take your expected Social Security benefits into consideration when doing planning. If several years of high SE contributions would greatly increase benefits, it may be worth the extra tax. Also, consider the effect of a higher income tax bracket when bunching income into one year and the potential use of income averaging. See your accountant.
- Watch the timing when selling crops or market livestock in your year of retirement. Farm inventory sold between your retirement date and the end of that year can count against your SS benefits for that year. If you exceed exempted amounts, your

benefits for that year will be reduced. However, if you sell crops or livestock after the year you begin taking SS benefits (and the crops or livestock were produced **before** you retired), benefits will not be reduced.

- If you wish to sell feed crops to the entering generation, you can do so and take payments as they fit your income and SE tax plan while spreading out the cost for the entering generation. If you sell and take a note as payment, the note is considered taxable income the year of sale, unless you elect to report it on the installment basis.
- An easy way to sell crops or livestock is to simply turn it over to the entering generation and let them assume any debt on it equal to the property value. If the buyer of your property takes over part or all of your debt in payment for the property, you must report taxable income to the extent you were relieved of debt.

Selling Breeding Livestock and Machinery:

When selling breeding livestock, machinery and equipment the sale income is not subject to SE tax. However, you will have to pay income tax on the difference between the adjusted basis (your cost) of these assets and the sale price. For example: Selling \$200,000 of machinery, cows and sows having an unclaimed depreciation amount of \$20,000 will result in \$180,000 of taxable income.

Machinery does not qualify for installment reporting to the extent of previously claimed depreciation. Therefore, it is nearly impossible to have a bulk sale of machinery without realizing a large income tax bill the year of the sale. Raised breeding livestock (never depreciated) can be reported to the IRS using installment sales reporting. This requires the filing of IRS Form 6252. Purchased breeding livestock (depreciation taken) does not qualify for installment sales when sold to a related party. See your tax professional for direction.

Leasing Equipment:

Leasing allows you to receive rent payments while retaining ownership and depreciation deductions. However, you need to be cautious when doing so. If you chose to lease please note:

- A “machinery only” lease is generally subject to self-employment tax.
- Combining a machinery lease with a land lease is an effective way to avoid self-employment tax.
- Leasing fails to add assets to the entering farmer’s net worth. A piecemeal sale may add to the buyer’s net worth.
- An alternative to leasing assets is to establish a rental contract for a set number of years at a given amount per year with no buy-out provision. Agree that the rental proceeds apply to the purchase price of the assets. Follow the rental contract with a simple sale agreement for the remaining value of the assets or gift the value. This will also help minimize self-employment tax.

This process can work for machinery as well as breeding livestock. Seek accounting assistance for information specific to your situation.

Gifts:

If you can afford to do so and it does not violate your business or personal goals, it may be prudent to gift crops, livestock, or pieces of machinery to the entering generation. If you gift an asset that still has an adjusted basis (un-depreciated value), that asset and the associated adjusted basis leaves your depreciation schedule and appears on the recipient’s depreciation schedule. If the asset has debt on it at the time it was gifted, in excess of the adjusted basis, the difference between the debt and the adjusted basis will be considered taxable income to you as the donor.

If you have a business entity such as a partnership, LLC or corporation, you can gift ownership units or shares to the entering generation as a means of transferring the business. See *Transferring The Farm Series #6-Gifting Farm Assets*. Also, be aware of federal and MN gift tax laws and rules.

Piecemeal Sales:

Selling a tractor this year, a planter next year, and a one-fourth interest in the combine the third year may be a good way to transfer ownership. It spreads your tax burden and lets the buyer accumulate assets gradually without paying a lot of principal or interest. Each time a sale is made, the purchaser can add the value to their net worth statement.

If you decide to sell your machinery one piece at a time, the IRS will probably not allow you to deduct depreciation on any asset that is not used in your business or is under a lease agreement. You may wish to continue farming some acres after retirement so that you can claim some depreciation.

If you have a business entity such as a partnership, LLC or corporation, you can sell ownership units or

shares to the entering generation as a means of transferring the business over time.

Hybrid Methods:

When transferring breeding livestock or machinery, it may make sense to combine the above three strategies (leasing/renting, gifting and piecemeal selling).

- You might lease/rent a few items which have a lot of depreciation remaining, while gifting and/or selling other items.
- You might gift some assets annually (usually low basis items) while selling piecemeal (high basis) other assets.
- If you operate within a business entity, you can sell or gift ownership units or shares of the entity, over time, as a means of transferring business ownership. See your accountant for assistance.

Charitable Remainder Trust:

A Charitable Remainder Trust allows a donor to transfer assets to a qualifying charity to avoid taxation on the disposal of the assets. The charity provides taxable income to the donor for a fixed number of years, much like an annuity, after which the remaining assets go to a designated charity. Rules vary for gifts with and without basis so consult your accountant or attorney. If a donor transfers grain or market livestock, they may avoid paying self-employment tax on the transferred asset. This can be a rewarding strategy for the donors along with providing retirement income for the future. However, it can be a complicated process so seek advice from your accountant and attorney.

NOTE: Gifting assets can create problems if you need to file for Medicaid if entering assisted living or a nursing home. For more information on this issue see *Estate Planning Series #9-Long-Term Health Care Planning*.

Summary:

Selling, gifting or leasing/renting farm assets can be a useful strategy for the transfer of your business assets. To facilitate this process, it is helpful to develop a plan for the use of these strategies - a goals list if you will. Outline your wishes or goals – what you want to happen and what you do not want to happen to the assets. Having this written goal list or outline will expedite the process. Seek advice from your attorney and accountant for information specific to your situation as you proceed.

Caution: This publication is offered as educational information. It does not offer legal advice. If you have questions on this information, contact an attorney.