

# PLANNING FOR THE FUTURE OF YOUR FARM

*Legal tools and strategies for farm transition and estate planning*

## STRATEGIES FOR TRANSFERRING EQUIPMENT AND LIVESTOCK

Machinery and livestock can be the most challenging farm assets to transfer to the next generation. That's because transferring these assets during life can have negative tax implications but waiting to transfer them at death can have timing issues for the farming operation. For many farmers, there is no perfect solution. However, there are several strategies that can pass your machinery and livestock to the next generation while addressing your goals for your farm transition situation. In this bulletin, we present these strategies and review the advantages and disadvantages of each.

### DETERMINE YOUR GOALS

While land is often a farm's most valuable asset, equipment and livestock are also significant assets on a farm's balance sheet. What are your goals for these assets? Assessing your current situation and determining your goals for transferring equipment or livestock is an important step in planning for the future. Ideally, your equipment and livestock goals will fit well with the other pieces of your farm transition or estate plan.

Consider these questions to help define your goals:

- Do you need income from the assets? If so, when do you need that income?
- Do you want to transfer the assets now to help the next generation?
- Do you want to keep control of the assets until your death or use them to some degree?
- Do you want to reduce your costs and liability risks for the assets?

## STRATEGIES TO IMPLEMENT YOUR GOALS

If you have a good idea of your goals, consider the different strategies that can help you accomplish those goals. Each strategy has advantages and disadvantages and analyzing these factors can help you decide which strategy best fits your goals and your farm transition plan. This can be a cyclical process, where understanding the implications of a strategy might alter your goals for transferring the assets.

### 1. Outright sale

Selling the assets outright is always an option. The advantages of an outright sale are that it generates income and relieves the owner of liability and the costs of maintenance. Additionally, selling now allows the next generation to use the assets for their current farming operation.

As for disadvantages, selling equipment and livestock means you no longer control that asset. Especially for equipment, you may have to buy, lease, or borrow in the future if you still have need for the equipment. However, the major disadvantage to selling equipment and livestock outright is that it will likely create a significant tax bill if the assets have little or no tax basis. When the assets are sold, there can either be capital gains or depreciation recapture issues. **Consider the following example:**

Farmer bought a tractor for \$100,000 and has taken \$90,000 of depreciation on the tractor. Farmer sells the tractor to Daughter for \$70,000. Farmer will pay ordinary income tax on \$60,000 of depreciation recapture, which is the sale price less the remaining tax basis in the tractor ( $\$70,000 - \$10,000 = \$60,000$ ).

### 2. Installment sale

Installment sales provide the benefit of income but instead of generating that income all at once, you receive it through a number of payments over a certain period of time. This period could be months or even years, giving you a steady flow of income. But an installment sale often advantages a buyer because it can help the buyer meet cash flow needs. If you're trying to transition the operation to the next generation, an installment sale is likely to help them be able to purchase the assets.

A disadvantage of an installment sale is that you still run into the problem of depreciation recapture. Even though you receive income over a period of time, the Internal Revenue Service (IRS) considers an installment sale to be complete in the year of you transfer the asset. You must pay all depreciation recapture that first year. Installment sales should be closely scrutinized with a tax professional. Many farmers who make an installment sale without tax advice may be unpleasantly surprised that the recapture is due in year one. **Consider the example on the following page:**

Farmer sells his tractor to Daughter for \$100,000, with \$25,000 due now and \$25,000 due every January 1 for the next three years. Farmer has completely depreciated the tractor so that it has a \$0 tax basis. The sale will create \$100,000 of depreciation recapture (sale price of \$100,000 less remaining tax basis of \$0). The IRS treats Farmer as having realized a \$100,000 financial gain in the year of the sale. Even though Farmer will not receive the full \$100,000 for three years, Farmer must pay the full income tax on the depreciation recapture in year one.

### 3. Gifting

If you do not need income from your equipment or livestock and there is someone you wish to receive the asset, gifting may be a good strategy. Because you are not gaining financially from the gift, there are no capital gains or depreciation recapture taxes due on the transfers. There may be federal estate tax implications in the future, however. Gifts exceeding the annual gift tax exclusion allowance, currently \$16,000 per gift, will either trigger a gift tax or reduce your federal estate tax exemption. Also, the person receiving the gift does not receive a stepped-up tax basis in the asset. For a detailed discussion on the strategies and implications of gifting, see the *Gifts Assets Prior to Death* bulletin in this series.

### 4. Inheritance

Another strategy if you do not need income from the asset is to transfer it at death through your estate. This strategy gives you control of the asset until your death, so is useful if you still need the asset. One disadvantage is that you remain responsible for maintenance, repairs, and liability.

There are clear advantages to the heirs who receive equipment and livestock through inheritance—the assets will have a stepped-up tax basis equivalent to the fair market value of the asset at the date of death. By inheriting the asset with a stepped-up basis, the recipient can re-depreciate the asset or sell it right away and pay little or no taxes. **Consider the following examples:**

*Scenario 1.* Farmer owns a tractor that he had fully depreciated. When Farmer dies, the tractor's fair market value is \$100,000. Daughter inherits the tractor. She receives the tractor with a stepped-up tax basis of \$100,000. She now has \$100,000 she can use for depreciation, or she can sell the tractor for \$100,000 and have no tax on the sale since the tax basis and sale are both \$100,000 and there is no gain to tax.

*Scenario 2.* Farmer gifts the tractor to Daughter while he is still alive. Daughter receives the tractor with Farmer's \$0 tax basis. She cannot depreciate the tractor and if she sells the tractor, she will pay income tax on the depreciation recapture.

## 5. Lease-to-own

A lease-to-own agreement appears similar to an installment sale in that the owner receives income from the arrangement over time and the buyer possesses the equipment, but a primary difference between an installment sale and lease-to-own is the tax implications. The tax treatment of a lease-to-own agreement differs from an installment contract in two ways. First, the IRS considers the lease payments that the owner receives to be ordinary income taxable in the year received. Second, the lease payments are fully deductible to the buyer. Another difference is that the purchase in a lease-to-own strategy occurs at the end of the lease term. Instead of having to pay all the depreciation recapture up front, the owner pays these taxes at the end, when the value of the machinery has significantly declined. While the IRS assesses all taxes on the gain from an installment contract in year one, a lease-to-own agreement allows you to spread out the tax burden. **Consider the following example:**

Farmer owns a tractor valued at \$100,000. He leases the tractor to Daughter for seven years for \$10,000/year. Farmer also gives an option to Daughter to buy the tractor at the end of the lease. The value of the tractor will be determined at the end of the lease when its value is less.

Farmer will report \$10,000 of income for each year of the lease. Farmer will pay depreciation recapture on the sale at the end of the lease, based on the value of the tractor at that time.

There are a few possible disadvantages to a lease-to-own agreement. First, the owner continues to retain ownership of the asset until the term of the lease has ended and the purchase is complete. By continuing to own the asset, the owner retains liability for it. This liability can be limited with liability insurance or an LLC. Second, the owner may still be responsible for maintenance and repair depending upon the terms of the lease arrangement.

Compared to other strategies, a lease-to-own agreement is also a bit more complicated because it requires the preparation of a lease and a later sales contract with a method for determining the purchase price when the lease ends. It is important that the lease be legitimate and charge a reasonable lease rate. Also, the option to purchase the lease asset at the end of the lease must use a reasonable method to determine the value of the asset at the end of the lease. Leases and options that use less than fair market value can be scrutinized and challenged by the IRS.

## 6. Transfer to a Limited Liability Company

A Limited Liability Company (LLC) can be a useful tool to transfer equipment. In this scenario, the owner transfers the machinery into an LLC. Then, the owner sells a percentage of the LLC each year to the recipient. The sale of the LLC ownership spreads out the potential tax liability and provides some liability protection to the owner. **Consider the following example on the next page:**

Farmer owns several pieces of machinery worth \$500,000. He transfers the machinery into an LLC. He then agrees to sell 10% of the LLC each year for the next 10 years to Daughter.

Generally, the sale of the LLC ownership will be subject to capital gains. However, the tax paid on the sale depends on the type of asset in the LLC and other factors. The tax implications of the strategy should be fully explored with a tax professional.

There are two potential disadvantages of this strategy. First is the cost of setting up a new LLC and administration costs of operating an LLC. Second, this strategy causes the owner to become a business partner with the recipient for as many years as the transition takes.

## ASSESSING THE STRATEGIES

There are many strategies for transferring ownership of equipment and livestock out of your hands and to the next generation. Using one or a combination of strategies might help you accomplish your goals. Assess each scenario carefully with your professional advisors and heirs to find those strategies that accomplish your goals for planning for the future of your farm.

## REFERENCES

26 U.S. Code Title 26 Section 453, Installment method  
<https://www.law.cornell.edu/uscode/text/26/453>

26 U.S. Code Title 26, Subtitle B Chapter 12, Gift tax  
<https://www.law.cornell.edu/uscode/text/26/subtitle-B>

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Find all our **Planning for the Future of Your Farm** resources at  
<https://go.osu.edu/farmplanning>

We completed this project with the generous financial support of the **USDA National Agricultural Library** and the **National Agricultural Law Center**, in partnership with **OSU Extension**.

*Planning for the Future of Your Farm* is a project of the OSU Agricultural & Resource Law Program, an OSU Extension program providing objective and timely legal research on agricultural issues affecting Ohio.



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