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Leasing, Conditional Sales Agreements, and the Future of Section 179

INTRODUCTION

Generally, a taxpayer that buys business or income-producing property (not held for sale) with a useful life of more than one year cannot deduct its full cost as an expense for that year. However, the Internal Revenue Code (Code) allows an annual deduction of a portion of the cost of the property. This deduction may be a deduction for depreciation, amortization or depletion.

For most tangible property, a depreciation deduction is provided under the Modified Accelerated Cost Recovery System (MACRS). IRS form 4562 is used to claim the deduction for depreciation.

SECTION 179 EXPENSE DEDUCTION AND ACCELERATED FIRST YEAR DEPRECIATION (AFYD)

There are two exceptions to the aforementioned rule. The first exception is the section 179 expense deduction and the other exception is the Accelerated First Year Depreciation (AFYD). Many taxpayers are eligible to deduct (in lieu of depreciation) the cost of most tangible personal property used in the active conduct of a trade or business pursuant to section 179 of the Code. The taxpayer can elect on Form 4562 to expense the cost of "eligible 179 property" in the year that the property was placed in service. "Eligible property" that qualifies for section 179 includes: machinery and equipment; property contained in or attached to a building (other than structural components), such as milk tanks, automatic feeders, barn cleaners, and office equipment; livestock, including horses, cattle, hogs, sheep, goats, mink and other fur-bearing animals; grain bins; single-purpose agricultural or horticultural structures; and agricultural fences and drainage tile. This deduction can be used for both new and used property.

In addition to, or in combination with, the section 179 expense deduction, taxpayers were allowed to deduct 50% of the cost of "qualified property" in the year that the property was placed in service as accelerated depreciation. "Qualified property" is tangible personal property that qualifies to be depreciated under the MACRS depreciation method with a recovery period of twenty years or less. This deduction can only be used when purchasing new property and the taxpayer must be the original user of the property.

RECENT HISTORY OF SECTION 179 AND AFYD

In 2013, the section 179 expense deduction was $500,000 per item, with a threshold of $2,000,000 before the deduction was limited. The AFYD limitation was 50% of the cost of the eligible property. However, these two deductions expired at the end of 2013 along with 53 other tax credits, deductions, and tax benefits. Beginning in 2014, the section 179 expense deduction dropped to $25,000 and the AFYD was eliminated entirely.

Prior to the end of 2013, a tax extender bill was introduced in Congress to extend the expired tax deductions, including the section 179 expense deduction at $500,000 and AFYD at 50%. The tax extender bill did not pass prior to the end of 2013 due to the inaction of Congress. So beginning in 2014, the section 179 expense deduction was $25,000 and there was no AFYD.

Congress debated the tax extender bill throughout most of 2014. Reports from Washington DC indicated that the tax extender bill would pass, but when? Finally, in December, Congress passed the tax extender bill which returned the section 179 expense deduction to $500,000 and AFYD to 50%. President Obama signed the bill on December 19, 2014. It is important to note that the bill extended the beneficial tax provisions only through 2014. Beginning in 2015, the section 179 expense deduction reverted back to $25,000 and AFYD was eliminated.

FARMERS IN A QUANDARY

Congress' inaction regarding the tax extender bill in 2013, and continuing through most of 2014, put farmers in a quandary. The farmers had to decide whether or not to make capital expenditures in 2014 and rely on the tax extender bill being passed, or not to make the purchases. As a result of this quandary, some farmers resorted to creative purchase arrangements where they called the purchase a "lease." Others entered into agreements where the purchase agreement contained an option to "lease" or "purchase," thereby allowing them the opportunity to take advantage of the section 179 expense deduction if the tax extender bill was passed. However, in many instances, the "lease" would not pass IRS scrutiny. The so-called lease was really a conditional sales agreement which would have received different tax treatment which was less beneficial. With the passage of the tax extender bill in December of 2014, the issue was resolved so the legitimacy of the leases never came into question.

Since the $500,000 section 179 expense deduction and the AFYD expired at the end of 2014, farmers are put in the same quandary in 2015 that they had in 2014. Should farmers make that capital expenditure in 2015 and count on Congress extending section 179 at $500,000 and continue AFYD? Does a lease of equipment, rather than a purchase, receive favorable tax treatment?

A lease is a viable alternative as long as the lease is a legitimate lease. This document examines the requirements of a true lease for tax purposes and the factors that turn the lease into a conditional sales agreement.

TAX TREATMENT OF A LEASE

If you pay to use property that you do not own in business, the payments are "lease payments." These lease payments paid for property used in business are deductible business expenses. On a Schedule F tax form, the payments would be deducted on line 24a.

A "lessor" is the person who owns the property and allows another to use the property in exchange for payments. A "lessee" is the person using the property and making payments in exchange for the use of the property.

Before trying to understand the tax advantages of leasing, it is important to understand the different types of leases. For IRS purposes, equipment leases generally fall into two categories, each with a different type of purchase option:

Non Tax-Oriented Leases: Legal ownership resides with the lessor, however, because the lessor is not considered to be at risk at the end of the lease, the lessee receives the tax benefits of ownership. In other words, the lease acts merely as security for a sale.

Tax-Oriented True Leases: Lessor maintains ownership of the equipment and there is a fair market value purchase option for lessee at the end of the lease.

When leases are structured as true leases, the lessee may claim the entire lease payment as a deductible business expense.

CONDITIONAL SALES AGREEMENT

If an agreement is found to be a conditional sales agreement, payments made pursuant to the agreement are non-deductible purchase payments. An agreement is treated as a conditional sales agreement if it provides that you will acquire title to, or equity in, the equipment upon completing a certain number or amount of payments. Being the "owner" of the equipment is a prerequisite to taking the section 179 expense deduction and depreciation. An "owner" is the person that has the benefits and burdens of ownership and not necessarily the owner of legal title. Therefore, if the purchaser is not considered the "owner," a conditional sales agreement may be the worst of two worlds – no business expense deduction for the payments and no depreciation deduction.

DISTINGUISHING A LEASE FROM A CONDITIONAL SALES AGREEMENT

The intent of the parties controls whether an agreement is a lease or a conditional sales agreement. How do the parties view the transaction? While the intent of the parties is important, for tax purposes the intent of the parties may be inferred from certain objective factors.

A conditional sales agreement (and not a lease) exists if any of the following are found:

The agreement applies part of each payment toward an equity interest.

The agreement provides for the transfer of title after payment of a stated amount.

The amount of the payment to use the property for a short time is a large amount of the amount paid to obtain title to the property.

The payments exceed the current fair rental value of the property (based upon comparisons with other similar properties).

There is an option to buy the property at a nominal price as compared to the property's value at the time the option can be exercised.

There is an option to buy the property at a nominal price as compared with the total amount required to be paid under the agreement.

The agreement designates a part of the payments as interest, or in some way makes part of the payments easily recognizable as interest.

CONCLUSION

For lease payments to be deductible as a business expense, the lease agreement must be a Tax-Oriented True Lease. If there are any factors present that show that the payments are intended to be creating equity in the equipment, the agreement will be deemed to be a conditional sales agreement. The payments pursuant to a conditional sales agreement are not deductible business expenses and the equipment is not depreciable unless the purchaser is considered the owner.

The importance of this issue depends on when Congress addresses the section 179 expense deduction and AFYD. If Congress' inaction in 2013 and 2014 is any indication, farmers may very well find themselves in the same position of not knowing whether or not to make capital expenditures in 2015. The best possible scenario would be for Congress to permanently establish section 179 at $500,000 and AFYD at 50% to provide farmers with the certainty that they need to make wise business decisions. However, this is unlikely to happen. If a lease is a viable alternative for the farmer, make sure that it is a Tax-Oriented True Lease.

Resources: 2015 RIA Federal Tax Handbook, (Thomson-Reuters Checkpoint), sec. 1900, 1941
2014 IRS Publication 225, Farmers Tax Guide, p. 22
2014 IRS Publication 535, Business Expenses, p. 9

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