DEPRECIATION, QBI DEDUCTION, AND LEASING ISSUES

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Outline

- Depreciation
- QBI Deduction
- Leasing
  - Land
  - Machinery

Tax Management Options: High Income Year

- Defer income
- Prepay expenses
- Retirement plan contributions
- Accelerated depreciation (section 179 deduction or bonus depreciation)
- Bunching itemized deductions
- Maximizing permanent tax benefits (e.g., hire children)

Farm Assets

- Eligible for:
  - Section 179 (asset specific; may use on only a portion of asset's value)
  - Bonus Depreciation (class by class; all or nothing)
  - MACRS Depreciation
    - New farm machinery and equipment; 5 year recovery period
    - Used farm machinery and equipment; 7 year recovery period

When Does Depreciation Begin and End?

- Property is placed in service when it is ready and available for a specific use, whether in a business activity, an income-producing activity, a tax exempt activity, or a personal activity.
- You stop depreciating property when you retire it from service, even if you have not fully recovered its cost or other basis.

Section 179 Deduction

- Notes:
  - Tangible personal property (e.g., machinery and equipment)
  - Grain bins
  - Single-purpose agricultural or horticultural structures
  - Must have been acquired by purchase
  - Can be new or used property

Section 179 Deduction (continued)

- Dollar Limits:
  - $1,080,000 for property placed in service in 2022
  - Reduced dollar limit for cost exceeding $2,700,000
  - Separate limits apply for sport utility vehicles and passenger automobiles
- Elect the Deduction
  - Complete Part 1 of Form 4562

Bonus Depreciation

- Notes:
  - Tangible property depreciated under MACRS with a recovery period of 20 years or less
  - You can elect, for any class of property, not to deduct the bonus depreciation allowance for all property in such class placed in service during the tax year.

Choosing Between Section 179 Deduction and Bonus Depreciation

- The TCJA increased bonus depreciation to 100% and applies to both new and used machinery.
- However, there are still some advantages associated with the section 179 expense deduction.
- Election:
  - Section 179: Can expense any part of qualifying asset.
  - Bonus Depreciation: Automatically applies unless taxpayer elects out on a class-by-class basis.

Farm Capital Recovery Period

Assets	Recovery Period (years)	Depreciation Allowed
Autos and Trucks	5	200% DB
Computers	5	200% DB
Farm Machinery (new)	5	200% DB
Farm Machinery (used)	7	200% DB
Fences	7	200% DB

Farm Capital Recovery Period (continued)

Assets	Recovery Period (years)	Depreciation Allowed
Grain Bins	7	200% DB
Irrigation Pivots	7	200% DB
Single Purpose Buildings	10	200% DB
Drainage Facilities	15	150% DB
Water Wells	15	150% DB

Farm Capital Recovery Period (continued)

Assets	Recovery Period (years)	Depreciation Allowed
General Purpose Farm Buildings	20	150% DB
Residential Rental Property	27.5	SL
Non-Residential Real Property	39	SL

Example 1: Choosing Depreciation Methods

- Tim Lange has $250,000 in net cash income before depreciation.
- His goal is to have enough depreciation to create net farm profit of $25,000
- Tim's depreciation on assets acquired before 2022 is $125,000. His equipment purchases in 2022 are $250,000 (all in the same class; 5-year property)
- If he does not elect out of bonus depreciation, he will have to expense the entire $250,000, leading to a net farm loss.

Example 1: Choosing Depreciation Methods, continued

- Tim can elect out of bonus depreciation and elect to expense $62,500 under section 179.
- His remaining basis in the new equipment before MACRS depreciation is $187,500 ($225,000 - $62,500). As 5-year property, regular MACRS depreciation will be $37,500 {($187,500 / 5) x 0.5 x 200%}.
- Subsequently, Tim will reach his net farm profit goal of $25,000.

Example 2: Farm Tractor Trade-In

- Amos Corngrower decided he needed a 4-wheel drive tractor. The list price was $397,000. The dealer will take Amos' 5-year old, 2-wheel drive tractor in trade, give Amos a $112,000 trade-in allowance and reduce the cash price to $285,000. The old tractor has a $61,262 remaining adjusted basis.

Example 2: Farm Tractor Trade-In, Continued

- Prior to the TCJA, this trade would have qualified as a tax-free, like-kind exchange. Amos would not have any taxable or reportable gain. His basis in the new tractor would have been $346,262 ($285,000 cash paid + $61,262 adjusted basis).

Example 2: Farm Tractor Trade-In, Continued

- Under the TCJA, this trade-in is now a taxable event and therefore must be reported as two separate transactions.
  - Amos reports the “sale” of his old tractor because a taxable exchange is reportable the same way as a cash sale.
    - Taxable gain = \$112,000 - \$61,262 = \$50,738
    - Basis of 4-wheel drive tractor = \$397,000

Example 2: Farm Tractor Trade-In, Continued

- If Amos is under the section 179 limit, Amos could elect a $50,738 section 179 expense deduction and eliminate the taxable gain from the exchange.

QBI Deduction – General Information

- Starting in 2018, a taxpayer other than a C corporation, can deduct up to 20% of qualified business income (QBI) from a partnership, S corporation, or sole proprietorship.
- QBI is the net amount of qualified income and deduction items for a qualified trade or business.

QBI Deduction – Excluded QBI Items

- The following items are not included in QBI:
  - Short-term or long-term capital gains or losses
  - Dividend income
  - Interest income other than interest income that is properly allocable to a trade or business
  - Any amount received from an annuity that is not received in connection with the trade or business
  - Reasonable compensation and guaranteed payments for services rendered paid to the taxpayer by any trade or business

Example 3. QBI Deduction

- Brandon Smith earned $100,000 qualified business income as a sole proprietor. He sold some land and recognized a $50,000 long-term capital gain. Brandon claimed $25,000 in itemized deductions, and his taxable income was $125,000. His taxable income adjusted for capital gain was $75,000. Brandon's QBI deduction is $15,000 ($75,000 x 0.20).

Farm Rentals

- Unlike nonfarm rentals, which are excluded from SE tax, farm rental treatment can be ambiguous
- Note that SE treatment of rentals may be separated from treatment for QBI purposes
- Straight cash rent to unrelated third party
  - No material participation under the arrangement
  - Report on Schedule E, no SE tax

Crop Share Lease

- Landowner receives a share of the commodity raised
- Payment varies based on production and commodity price – element of risk
- SE income if landowner materially participates, Schedule F
- Without material participation:
  - No SE tax
  - Report on Form 4835, flows to Schedule E like cash rent

Material Participation

- Requires an arrangement between landowner and tenant
- Landlord meets 1 or more of 4 tests:

1. You do at least three of the following:
    - Pay at least ½ of direct costs
    - Furnish at least ½ of tools and equipment
    - Advise or consult with client
    - Inspect the production activities periodically

Material Participation, Continued

- Landlord meets 1 or more of 4 tests, continued:

2. Regularly and frequently take an important part in decisions
3. You work 100 hours or more spread over 5 weeks or more
4. You do things that, in their totality, show that you are significantly involved

Renting to a Controlled Entity

- At risk of SE tax if
  - Rent exceeds market value **and**
  - There's a connection between
    - The rental arrangement and
    - The arrangement in which the landowner materially participates
- *Martin* case puts burden on IRS to show nexus if rent is market value or less

Renting to a Controlled Entity

- Example 4: Renting to a Family Partnership
  - John and Jane Johnson are siblings who farm together in a farm partnership.
  - Jane leases her farm land to the partnership for the average cash rental rate in the county. In terms of the rental arrangement, Jane does not materially participate.
  - Jane reports her farm rental income form the farm land on Schedule E. The rental income is not subject to SE tax, even though Jane material participates in the partnership.

Leasing Machinery

- Income from leasing machinery is subject to self-employment tax if:
  - Not leased with real property, and
  - Rental activity is a trade or business

- Example 5: Self-Employment Tax on Rental Income
  - Randy Rogers retired from farming and decided to lease all his equipment to another farmer. In 2021, Randy entered into a 5-year lease with Sonny Saunders for equipment valued at $200,000. The annual lease payments are $30,000 in 2021, $27,000 in 2022, $24,000 in 2023, $21,000 in 2024, and $18,000 in 2025.

Leasing Machinery

- Example 5 (continued):
  - Because this is a 5-year lease for all of Randy's equipment and the equipment is not being leased with real property, Randy is likely in the trade or business of renting personal property. He must pay self-employment tax on the rental income.

Leasing Machinery

- Operating Lease
  - Paying for use of property for a term
  - Rental payments are deductible
  - If purchase after lease, pay fair market value
- Capital Lease (Conditional Sales Contract)
  - Purchase over time
  - Payments not deductible, cost of equipment is depreciated

Leasing Machinery

- Conditional sales contract if any apply:
  - Part of each payment goes to equity
  - Title passes after stated amount paid
  - Short term rent represents a large part of item cost
  - Paying much more than fair rental value
  - Option to purchase at nominal price
  - Part of payments is interest

Financial Management Series

Web Site:

https://ag.purdue.edu/commercialag/home/resource/2020/10/financial-management/