Farm Management

What should you do with ag equipment at retirement time?

Farm & Family

BY RYAN PROCHASKA

WITH farm prices getting lower and farmers aging, more farmers are thinking about retiring within the next five years.

One major concern for retiring farmers is the amount of taxes paid when selling their equipment. Recaptured depreciation is not considered a capital gain and will be taxed as ordinary income the year the equipment is sold. If your equipment is fully depreciated, all proceeds will be taxed as ordinary income.

The two primary questions that must be answered when addressing this concern are: Do we have a next generation of farmers? And do we need the proceeds from the equipment to live comfortably during retirement?

Farming heirs

If you have a taxable estate and/or can live comfortably without the sales proceeds of your equipment, gifting is an option. Gifting will reduce your taxable estate, which may reduce or eliminate estate taxes.

In Minnesota, only gifts within three years of death are included in your estate. If you gifted $200,000 of equipment in 2012 and passed away with an estate valued at $1.5 million in 2016, you would have saved $10,000 in taxes. One downside of gifting is your basis transfers. If your basis was zero, your heirs' basis will be zero, and they won't be able to depreciate the equipment.

If you want your heirs to be able to depreciate the equipment, consider letting them use the equipment subject to their payment of upkeep, maintenance and repairs during your lifetime, and giving them the equipment as an inheritance. Upon your death, your equipment receives a step up in basis to the fair market value, and your heirs can depreciate the equipment.

If gifting is not an option, you need to determine if you want or need fair market value for your equipment to enjoy retirement. If you want to help your heirs transition into the farming operation, you may want to consider selling them the equipment at a discount on a promissory note.

You also could lease the equipment to your heirs at an affordable rate with an option to purchase at the end of the lease. Your heirs' basis would be the purchase price of the equipment, and they could depreciate that amount. Leasing or selling the equipment on a promissory note may eliminate your heirs' need to get a loan at the bank.

No next generation

When there is no next generation, retiring farmers have four main options:

- selling the equipment piece by piece over a period of years
- using installment sales
- selling all the equipment in one year
- creating a Charitable Remainder Trust

The primary goal of piecemeal selling is to reduce taxes by selling different pieces of equipment over a period of time and having more of the proceeds taxed at a lower bracket. Before selling equipment piece by piece, consider the rate at which the equipment's value is depreciating. If the value of equipment is depreciating rapidly, you may be better off selling it all at once. Even though a larger portion of the proceeds will be taxed at the highest bracket, you may have a higher net profit than selling the depreciated equipment at a lower price with a larger portion of the proceeds being taxed in lower brackets.

An installment sale is selling all equipment in any given year, but getting paid over several years. Because all recaptured depreciation must be reported the year of sale, an installment sale is not a good option for fully depreciated equipment.

Let's say you purchased a piece of equipment for $300,000 and depreciated $100,000, giving you a basis of $200,000. If you sold it for $250,000, $100,000 would be taxed as ordinary income the year it was sold due to recaptured depreciation. Any interest payments would be paid as ordinary income the year it was received.

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Sometimes the best option is to sell all of your equipment upon retirement and pay the tax. No one wants to give the government more money than they need to, but selling your entire inventory at once may also maximize the money you keep. With farm prices decreasing, there is no guarantee what the equipment will be worth in one, three or even five years. The tax will always be there, so you may decide it's best to eliminate the risk of depreciation by selling all of your equipment at once.

The final option is creating a Charitable Remainder Trust. After creating the trust, the farm equipment is gifted to the trust. The trustee then sells the equipment at an auction, and the proceeds are invested. The investment provides you and your spouse income for life.

If the trust is a unitrust, you receive a fixed percentage of the investment amount, i.e. 5%, each year. Because you are receiving a percentage of the investment, the amount you receive each year will depend upon the performance of the investment.

If, however, it is an annuity trust, you receive a fixed amount, i.e. $25,000, each year, regardless of how the investment is performing. After you and your spouse pass away, you can designate your children to receive income for a maximum period of 20 years. At the end of that 20-year period, the remaining balance of the investment goes to the charity you designated in the trust.

Whether gifting or selling equipment, it is important to consider the tax consequences and to document all transactions. I recommend consulting with your accountant and attorney to discuss the consequences of all sales and gifts.

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