

CHAPTER 5

MANAGING THE TIMING OF INCOME AND DEDUCTIONS

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Introduction

Tax management is essential in ensuring that a farm operator pays no more than the legally required amount of tax. Several factors produce the opportunity or necessity for tax planning. Farm businesses are subject to all of the general economic market factors that affect non-farm businesses. In addition, farm businesses also see wide fluctuations in income due to weather, disease, and other natural phenomena. Because marginal tax rates increase as income increases, the additional tax paid in a high income year may not be offset by the taxes saved in a low income year. Fortunately, most farm businesses calculate their income on a cash basis of accounting, which allows great flexibility in managing the ups and downs of farm income. A primary goal of tax management is to avoid wide fluctuations in annual income in order to avoid swings in marginal tax rates.

Marginal Federal Income Tax Rate

A taxpayer's *marginal federal income tax rate* is the rate that applies to the taxpayer's last dollar of taxable income. Each year the IRS publishes rate schedules for each filing status, adjusting the taxable income brackets for inflation. Figure 5.1 shows the 2011 tax rate brackets for a married taxpayer filing a joint return.

MANAGING THE TIMING OF INCOME AND DEDUCTIONS

FIGURE 5.1 2011 Federal Income Tax Rates Joint Returns

Married filing jointly or Qualifying widow(er)			
If taxable income is over	but not over	the tax is	of the amount over
\$0	\$17,000	10%	\$0
17,000	69,000	\$1,700.00 + 15%	17,000
69,000	139,350	9,500.00 + 25%	69,000
139,350	212,300	27,087.50 + 28%	139,350
212,300	379,150	47,513.50 + 33%	212,300
379,150	-----	102,574.00 + 35%	379,150

Example 5.1 — Marginal Federal Income Tax Rate

Bob is a married farmer who has \$44,238 of taxable income in 2011. Applying the 2011 tax rate schedule in Figure 5.1, the first \$17,000 of income is taxed at a 10% rate. The remaining \$27,238 (\$44,238 – \$17,000) is taxed at a 15% rate. Bob's marginal federal income tax rate is 15%.

Because the federal income tax rate brackets are indexed for inflation, a taxpayer with the same amount of income this year as last year might find more of that income being taxed at the lower rates this year.

Effective Marginal Tax Rate

The marginal federal income tax rate is not the only consideration in tax planning. You should also consider the *effective marginal tax rate* that results from applying all of the tax rules. This concept looks at the total increase in tax as a percentage of increased income, taking into consideration the numerous tax benefits that are phased out as income increases (for example, the child tax credits, the education credits, and the deduction for student loan interest).

Furthermore, the effective marginal tax rate includes the impact of self-employment (SE) tax, alternative minimum tax (AMT), and state and local income taxes. SE tax is a significant component of a farmer's total tax liability. It is comprised of two components, a 12.4% tax for social security (retirement, survivor, and disability) benefits and a 2.9% tax for Medicare benefits, for a total 15.3% rate. The 12.4% social security tax rate is reduced to 10.4% for SE income earned in the tax year beginning in 2011. For tax years beginning in 2012 and thereafter, the rate is scheduled to go back to 12.4%.

Taxpayers can deduct one-half of the SE tax (calculated without regard to the 2011 rate reduction), which reduces the effective tax rate for SE tax to 13.07% (11.36% for tax years beginning in 2011), for taxpayers in the 15% federal income tax bracket with no state or local income tax.

Example 5.2 Marginal Federal Income and SE Tax Rate

Consider Bob from Example 5.1. Each additional dollar of farm income will cost him 11.36¢ in net SE tax because he is allowed to deduct one-half of the unreduced SE tax from his taxable income before computing his income tax liability. Bob's effective combined marginal federal income and SE tax rate is 26.36% (15% income tax plus 11.36% net SE tax).

The *net earnings from self-employment* that are subject to the social security component of the SE tax are capped at \$106,800 for 2011 (a limit that is adjusted for inflation each year.) Because self-employment income is reduced by 7.65% (half of the unreduced total SE tax rate) when computing the SE tax, net earnings from self-employment are calculated at 92.35% (100% – 7.65%) of SE income. Therefore, in 2011, taxpayers are subject to the 10.4% social security component of the SE tax on a maximum of \$115,647 (\$106,800 ÷ 0.9235) of SE profits.

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Because the \$106,800 cap applies only to the social security component of the SE tax, the marginal SE tax rate decreases to 2.9% (the Medicare tax rate) on net earnings from self-employment above this cap.

Example 5.3 Reduction of SE Tax Rate

Guadalupe is a married farmer who has \$115,647 of net farm income in 2011. Her SE tax is computed as shown in Figure 5.2.

FIGURE 5.2 Guadalupe's SE Tax on \$115,647 of Net Farm Income

Net farm income	\$115,647
Deduction (7.65% × \$115,647)	<u>– 8,847</u>
Net earnings from self-employment	\$106,800
SE tax rate for 2011 (10.4% + 2.9%)	<u>× 13.3%</u>
Guadalupe's SE tax for 2011	<u>\$ 14,204</u>

If Guadalupe's net farm income increases by \$100, her net earnings from self-employment increase by \$92.35 and her SE tax rate on the additional \$92.35 is 2.9%. Therefore, the \$100 increase in net earnings from farming increases her SE tax by only \$2.68 (2.9% × \$92.35).

✓ Observation

No Itemized or Personal Exemption Deductions for SE Tax

Farmers often pay more SE tax than federal income tax because neither itemized deductions (or the standard deduction) nor personal exemption deductions are allowed when computing SE tax. For example, a married farmer with two children whose only income is a \$50,000 net profit from farming will pay a \$6,141 ($\$50,000 \times 0.9235 \times 13.3\%$) SE tax in 2011. For federal income tax purposes, the farmer's taxable income is reduced to \$20,529 after subtracting an \$11,600 standard deduction, a \$14,800 ($4 \times \$3,700$) personal and dependent exemptions deduction, and the \$3,071 deduction for 50% of the SE tax, and the farmer will pay only \$2,229 of federal income tax (before any available credits).

An important point concerning marginal tax brackets is that a taxpayer does not get a dollar for dollar tax benefit for each dollar of deductions. Bob, in Example 5.2, reduces his federal tax by 26.36¢ for each \$1 of tax deduction. If Bob spends \$1 to acquire that tax deduction, he will save 26.36¢ in tax. However, his out-of-pocket cost is 73.64¢ (the \$1 spent minus the 26.36¢ saved in taxes).

Because a taxpayer incurs a personal out-of-pocket cost for a portion of each dollar spent, it is unwise to spend money just to get tax deductions. The taxpayer must gain something of value, in addition to tax savings, to justify additional expenses. This may seem obvious, but there are many taxpayers who want to spend money just to avoid tax.

It is also important to recognize that marginal tax brackets are just that—marginal. The marginal tax bracket applies only to each incremental dollar of income.

Example 5.4 Application of Marginal Tax Rate

If Bob (in Example 5.1) increases his taxable income above \$69,000, he will move into a 25% marginal federal income tax bracket (see Figure 5.1). Therefore, if Bob's income rises from \$69,000 to \$69,001, the federal income tax is 25¢ of that last dollar, **but only of the last dollar**. Moving into a 25% marginal bracket does not mean that the government will take 25¢ of **every** dollar. All of the income up to \$69,000 is still taxed in the lower brackets.

 **Observation****Tax Rates Change**

It is important to remember that tax rates have changed over the years and could change again at any time. It is important to factor these changes into farm management decisions.

Tax-planning strategies for a cash basis taxpayer often involve delaying income or prepaying expenses to move income from a higher effective marginal tax rate to a lower one. A farmer may get a tax benefit by prepaying supplies, but even though the farmer can ultimately use the supplies, the additional cost of pre-purchasing must be recognized. This cost typically includes the time value of money—interest expense on money borrowed or lost interest income on money taken from savings to make the prepayments. Therefore, a taxpayer gains the most by prepaying expenses that will be used early in the next year. A taxpayer must consider whether his or her marginal bracket is high enough that the tax savings justify taking on a current cost that could have been delayed.

Deferring Income

Deferral is the concept that underlies most year-to-year tax planning. The goal is to delay reporting taxable income as long as possible, provided that the income will be taxed at the same or a lower marginal tax bracket when it is reported in a later year.

**Cross-Reference****Constructive Receipt of Income**

See page 5 of the 2010 IRS Publication 225, *Farmer's Tax Guide*, for an explanation of when income has to be reported because it is available to you.

Deferring taxable income can be accomplished in one or both of two ways:

1. Delaying the receipt of income to a later year, or
2. Accelerating tax deductions to an earlier year.

A deduction taken this year is not available for a later year. Similarly, if income is not reported this year, it must be reported in a later year. **Therefore, deferral does not affect the total amount of income reported over a period of years.**

If deferral does not ultimately change the amount of taxable income reported, what does it accomplish? Potentially, it should accomplish two things. First, it can defer the payment of tax for a period of time, as Example 5.5 illustrates.

Example 5.5 Income Deferral

Jane has a choice of selling \$10,000 of crops on December 31, 2011, or waiting until January 1, 2012.

Jane is in a 28% effective marginal tax bracket each year, so the tax on these sales will be \$2,800 in either event. However, if Jane takes the \$10,000 on December 31, 2011, she will pay that \$2,800 on March 1, 2012. If she waits until January 1, 2012, she will not have to pay that \$2,800 in tax (plus the SE tax on the additional income) until March 1, 2013—a full year later.

Jane should analyze this deferral by deciding whether the loss of the use of \$10,000 for one day (December 31, 2011, to January 1, 2012) is more than made up by gaining the use of \$2,800 (plus the SE tax) for one year (March 1, 2012, to March 1, 2013). Clearly, it would benefit Jane to defer the sale of her crops by one day if her investment return on the deferred tax exceeds the savings from the 2% SE tax rate reduction for 2011.

The second benefit that deferral can sometimes accomplish is taxing the deferred income at a lower marginal tax bracket when it is reported. If this happens, the taxpayer not only delays the payment of tax but pays less tax as well.

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Example 5.6 Income Deferral and Tax Reduction

Suppose Jane (from Example 5.5) is in a 28% effective marginal bracket in 2011 and will be in a 25% effective marginal bracket in 2012. Pushing \$10,000 of crop sales from 2011 to 2012 not only delays the payment of tax by one year, it also reduces Jane's tax on this \$10,000 from \$2,800 to \$2,500. Jane would save \$300 due to the lower 2012 tax rate.

There are two strong cautions to consider when deciding to use the deferral concept. The first is that marginal tax brackets can cut both ways. In the above example, Jane saved \$300 due to the lower 2012 marginal tax rate. However, suppose Jane focuses only on delaying the tax and forgets that the marginal tax bracket could go up?

Example 5.7 Income Deferral and Tax Increase

Suppose Jane (from Example 5.5) pushed \$10,000 of sales from 2011 to 2010, is in a 25% effective marginal bracket in 2011, and is in a 28% effective marginal bracket in 2012. Jane has delayed paying \$2,500 of tax from March 1, 2012, to March 1, 2013. However, on March 1, 2013, she owes \$2,800, not \$2,500, which is \$300 more. Unless Jane can earn \$300 on \$2,500 between March 1, 2012, and March 1, 2013 (a 12% rate of return), her tax planning was a mistake.

The second caution in using the deferral concept is that it may entail risks beyond taxes. For instance, delaying sales to defer income may subject the taxpayer to price fluctuations.

Example 5.8 Income Deferral and Loss of Income

Suppose Jane (from Example 5.5) delayed \$10,000 of sales from 2011 to 2012. Further assume that Jane is in a 28% effective marginal bracket in 2011 and a 25% effective marginal bracket in 2012. However, suppose that after delaying her sale into 2012, Jane received only \$7,000 instead of the \$10,000 she would have received in 2011. Figure 5.3 shows a comparison of Jane's after-tax positions.

FIGURE 5.3 After-Tax Effect of Delayed Sale

	<u>2011 Sale</u>	<u>2012 Sale</u>
Cash received	\$10,000	\$ 7,000
Tax paid	<u>- 2,800</u>	<u>- 1,750</u>
Net cash	<u>\$ 7,200</u>	<u>\$ 5,250</u>

Taxes were deferred, as well as reduced. However, Jane ended up with less after-tax income because of the lower sales price.

Installment Sale Reporting

If a sale qualifies for installment reporting, the gain is included in gross income in future years as payments are received from the buyer. Such a sale avoids the risk of price changes discussed earlier under deferring income, but it does not eliminate the risk that the buyer might default on payment. The seller eliminates market risk but takes on the risks of being the creditor.

**Cross-Reference****Installment Sale Tax Rules**

See Chapter 10 of the 2010 IRS Publication 225, *Farmer's Tax Guide*, for an explanation of the installment sale reporting rules.

Installment reporting may be especially useful when a significant dollar amount of farm assets is being liquidated (including sales to family members) because it can spread the income over future years in which the seller's effective marginal tax rate may be lower.

All three of the following requirements must be met for a sale to qualify for installment reporting.

1. There is a gain on the sale. (Losses are reported in full in the year of sale.)
2. At least one payment is received in a tax year after the tax year of sale.
3. The gain is not ordinary income from depreciation recapture arising from the sale of depreciable property, such as purchased breeding livestock, equipment, and certain farm buildings.

Farm producers who report on a cash basis and who are not required to account for inventory on their tax returns can report the sale of crops and market livestock on the installment method. (Accrual-basis taxpayers and those required to account for inventory on their tax returns cannot report the sale of their products on the installment method, although they can use it for qualifying asset sales.)

If the installment sale contract does not include an interest charge, or if it includes an interest charge that is lower than a required rate, the IRS will treat part of the sales price as interest that is taxed as ordinary income. The minimum rate of interest that must be charged to avoid the adjustment is called the Applicable Federal Rate (AFR). The AFRs are published monthly by the IRS for short-term (not more than 3 years), mid-term (more than 3 years but not more than 9 years) and long-term (more than 9 years) contracts. There are two notable exceptions to the requirement that the AFR be charged:

1. The total sales price is \$3,000 or less.
2. All payments under the contract are to be made within 1 year of the sale date.

In addition, no interest needs to be charged on any payment made within 6 months of the sale date, regardless of the total length of the contract.

**Note****Related-Party Farmland Rate**

A special rule allows sellers to charge the lesser of the AFR or a 6% rate compounded semi-annually for the sale of farm land (not buildings) between family members. This rule applies only to a total of \$500,000 of land sales in any given tax year. (With the currently low AFRs, this provision is irrelevant but it has been useful with historically higher AFRs.)

Example 5.8 Installment Sale of Crops

Samantha expects to be in the 25% tax bracket this year due to an exceptionally good apple crop. She is normally in the 15% tax bracket. Sam is concerned that the market price may drop, so she is reluctant to defer income by keeping her crop in storage and selling it next year. She trusts the creditworthiness of the company that has been buying her apples for the last 12 years. Therefore, Sam entered into an installment sale with the buyer. She sold \$50,000 of apples in November (based on the current market price at that time) and agreed to take payment the following January. Even though the AFR rules do not apply (because all contract payments will be made in less than 1 year), Sam convinced the buyer to pay 4.45% interest on the unpaid balance.

Sam reports the \$50,000 of apple income next year as ordinary income from the sale of her crop when she receives the payment. She also reports the interest income that accrues through the date of payment.

The sale of farm land can be reported in much the same way. The computations are somewhat more complex because gain must be calculated by subtracting the taxpayer's cost basis and any expenses of sale from the sales price. This gain is then prorated and reported by the seller as payments are received.

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Generally the terms of payment extend beyond 1 year, and an amortization schedule is required to determine the amount of principal and interest included in each payment received.

Example 5.9 Installment Sale of Land

Maurice sold land for \$1,000,000. He had acquired the land 30 years ago for \$200,000. He paid his real estate agent, attorney, appraiser, and surveyor \$75,000 in closing costs. Maurice agreed to accept a \$100,000 cash down payment plus \$100,000 each year for 9 years, with interest of 6% on the unpaid balance. Maurice's gain on the sale is calculated as follows:

Sale price	\$1,000,000
Less: basis	– 200,000
Less: expenses	<u>– 75,000</u>
Gain	<u>\$ 725,000</u>

Maurice's gross profit percentage is 72.5% ($\$725,000 \text{ gain} \div \$1,000,000 \text{ sale price}$), so 72.5¢ of each dollar of principal received on the sale is taxable. In the year of sale Maurice must pay tax on \$72,500 ($72.5\% \times \text{the } \$100,000 \text{ down payment}$). Taxation of the balance of the gain is deferred until Maurice receives each payment during the next 9 years.



Caution

Property Sold Subject to Debt

The property sold may be subject to debt that is assumed by the buyer. Such sales require complex calculations and may trigger unexpected tax results for the seller. Taxpayers should seek competent tax advice in such situations.

As stated previously, depreciation recapture from the sale of purchased breeding livestock, equipment, and certain buildings cannot be reported on the installment method. This may result in a surprise to the taxpayer who sells on a deferred-payment basis and expects to pay no tax until the cash is actually received.

Example 5.10 Sale of Equipment

Amiyah sold some equipment for \$100,000. The equipment originally cost her \$125,000 but she had deducted a total of \$80,000 of depreciation by the time of the sale. Therefore, her adjusted basis in the equipment is \$45,000 ($\$125,000 - \$80,000$). Amiyah incurred no expenses on the sale so her gain is calculated as:

Sale price	\$100,000
Less: basis	<u>– 45,000</u>
Gain	<u>\$ 55,000</u>

Amiyah agreed to allow the buyer pay \$20,000 down and \$20,000 annually for the next 4 years, plus interest of 6% on the unpaid balance. Amiyah's gain is 55% ($\$55,000 \div \$100,000$) of her sale price so she expects to pay tax in the year of sale on \$11,000 ($55\% \times \$20,000 \text{ down payment}$). However, all of the gain arose from depreciation recapture, which results in the full \$55,000 being taxable to Amiyah in the year of sale.

Accelerating Expenses

In addition to deferring income, taxpayers may reduce taxable income in the current year by accelerating expenses. Cash-basis taxpayers can accelerate the deduction of expenses by prepaying farm expenses for the coming year. Three rules must be met in order to deduct such prepaid expenses.

1. The expenditure must be a payment and not merely a deposit.
2. The payment must be made for a legitimate business purpose, such as securing a lower price.
3. The deduction must not materially distort income.

Taxpayers who are not farmers (and in some rare cases those who are farmers) can deduct prepaid expenses only to the extent that the expenses do not exceed 50% of the total of non-prepaid expenses.



Cross-Reference

Prepaid Expenses

See pages 19–22 of the 2010 IRS Publication 225, *Farmer's Tax Guide*, for an explanation of the prepaid expense rules.

The deduction of certain expenses cannot be accelerated even if they are prepaid. These generally include interest, rent, insurance, and real estate taxes. Taxpayers may pay and deduct the interest accrued on loans up to year end, but they cannot deduct advance payments of next year's interest until next year. Payments for rent and insurance cannot be currently deducted to the extent that the rental or insurance coverage period exceeds 12 months. If the payment provides a benefit for more than 12 months, the taxpayer must prorate the payment and deduct only the portion with current year benefit.

Example 5.11 Prepaid Rent

Guadalupe rented land from her neighbor for \$12,000 under a 12-month lease agreement. The term of the lease runs from December 1 to November 30. When Guadalupe makes her \$12,000 lease payment in November, she is able to deduct the full amount in the year of payment.

However, if Guadalupe's lease is for a 24-month term (\$24,000) and Guadalupe paid the full lease amount at signing in November, her deduction in the year she made the payment is limited. Guadalupe can deduct only \$1,000 ($\$24,000 \div 24$ months) in the year she made the payment. She can deduct \$12,000 in the next tax year and the remaining \$11,000 in the year after that year. If she paid only \$12,000 at signing, she could deduct the full \$12,000 in the year she made the payment because the benefit of the payment does not exceed 12 months.

A common year-end tax-savings tactic for cash-basis taxpayers is to pay off open accounts because these taxpayers can claim expense deductions only when the amounts actually paid. Before making advance payments on other items, farmers should consider clearing their open accounts.

Another tactic to accelerate expenses is to move needed repairs and maintenance up to the current year. For instance, painting a barn or repairing machinery could be moved from the following spring to the current year.

Managing Depreciation Expense

Deductions can also be accelerated by maximizing the expense deductions available for depreciable property. (See Chapter 4 for more information about depreciation.) Taxpayers can manage the tax effect of depreciation by choosing the depreciation method and the timing of acquisitions. As noted in Chapter 4, taxpayers can deduct 100% additional first-year depreciation (AFYD) for the cost of new equipment, livestock, and buildings purchased and placed in service in 2011. For 2012 purchases, the AFYD deduction is 50% of the purchase price of eligible assets. In addition, there is the direct expense election under Internal Revenue Code Section 179 (referred to as § 179). Even for the cash-basis taxpayer,

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equipment is depreciable when it is placed in service. This can generate a deduction without paying any cash if equipment is purchased on a deferred payment plan.

The fundamental way to maximize deductions for depreciable property is to use accelerated depreciation, AFYD, and the § 179 deduction, if allowed, rather than slower depreciation methods.

The timing of acquisitions can also affect the amount of depreciation that is allowed. For example, taxpayers must use a mid-quarter convention rather than the half-year convention if the depreciable basis of property purchased in the last quarter of the tax year is more than 40% of the depreciable basis of all property purchased during the year. Many farmers want to move a planned purchase from the following year to the current year to gain depreciation deductions on the new item. However, accelerating the purchase may trigger the mid-quarter convention, which can result in not only little depreciation gained on the accelerated purchase, but also a reduced total of depreciation deductions for the year.

Example 5.12 Less Depreciation

Don's only equipment purchases were \$40,000 in September. The equipment is 7-Year MACRS property, and Don is eligible to use rapid depreciation. With the half-year convention, Don could deduct \$4,284 of depreciation.

In a tax-planning attempt, Don moved \$27,000 of equipment purchases scheduled for next year up to December. This triggers the mid-quarter convention ($\$27,000 \div \$67,000 = 40.3\%$). Don's total allowable depreciation on the entire \$67,000 of equipment is reduced to \$3,940. Don tax-planned himself into less depreciation by triggering the mid-quarter convention.

This example demonstrates that you must be very cautious in accelerating depreciable asset purchases as a tax-planning move. The mid-quarter convention is a wrinkle that must be considered.

As a corollary, however, if the original purchases were made early in the year, year-end purchases that trigger the mid-quarter convention may increase the allowable depreciation deduction.

Example 5.13 More Depreciation

Suppose Don (from Example 5.12) purchased \$40,000 of equipment in March and \$27,000 in December. The mid-quarter convention is triggered and his total depreciation on the purchases is \$8,224. If the timing of his purchases had not triggered the mid-quarter convention, his allowable depreciation on the \$67,000 under the half-year convention would be \$7,176.

The AFYD deduction and the § 179 direct expense election were ignored in Examples 5.12 and 5.13, but they can be significant tax planning tools when available. There are some additional considerations regarding AFYD and § 179.

1. The full deduction is allowed even if property is purchased on the last day of the year.
2. To maximize the acceleration of deductions, § 179 should be taken on property in the class with the longest life. This will increase the deductions in the earlier years of the properties' useful lives.
3. A taxpayer may benefit from delaying purchases into later years to take greater advantage of § 179 each year.

Example 5.14 Maximizing § 179

Jazlyn purchased \$600,000 of used equipment in October 2011 and made no purchases in 2012. In 2011, she expensed \$500,000 under § 179 and depreciated the other \$100,000 of her cost using rapid depreciation and the mid-quarter convention. She can deduct \$503,750 of depreciation and § 179 expenses in 2011 and \$28,880 of depreciation in 2012.

If Jazlyn delayed \$100,000 of her purchases until 2012, she could claim a \$500,000 § 179 deduction in 2011 and a \$100,000 § 179 deduction in 2012. She could not claim any depreciation because her entire purchase price would be recovered through § 179 deductions.

Lease vs. Purchase of Equipment

Leasing is often considered to be a way of reducing taxable income because deductible lease payments can be greater than deductible depreciation and interest. However, taxpayers need to carefully analyze the after-tax cost of a lease versus purchase. If the total cost of leasing is greater than the total cost of owning, the tax savings have to exceed that difference to make leasing the better after-tax alternative.

If leasing is the better option, taxpayers must be sure the transaction will be treated as a true lease rather than as an installment purchase contract. Over the years, IRS rulings and court decisions have indicated that the following factors result in a transaction being treated as a purchase rather than a lease.

1. The agreement applies part of each payment toward an equity ownership interest.
2. The lessee receives title to the property upon payment of a stated amount under the contract, in contrast to an *option* to purchase at reasonable market value.
3. The amount the lessee pays for a short period of time is nearly the amount that would be paid to buy the property.
4. The lessee pays much more than the current fair rental value of the property.
5. The lessee can purchase the property at a nominal price compared to the value of the property at the time of purchase (for example, \$1).
6. The lessee has the option to buy the property at a nominal price compared to the total amount the lessee has to pay under the lease.
7. The lease designates part of the payments as interest, or a part of the payments is easy to recognize as interest.
8. The lessee has an equity interest in the leased item during the lease period.

Trade-ins and Leasing

Trade-ins on leased items can create tax problems. If the lessee has an equity interest in the equipment as a result of the trade-in, the transaction does not qualify as a lease. To preserve lease treatment, the transaction must be structured as a sale of the old equipment. This is a taxable sale for which the gain is generally reportable on IRS Form 4797, Sale of Business Property, as ordinary income that is not subject to self-employment (SE) tax. This ordinary income can then be offset by deducting the lease payment on the new equipment.

Example 5.15 Trade-In Resulting in Installment Purchase

Brenda traded her old tractor for what she thought was a lease of a new tractor. However, the dealer applied the \$25,000 trade-in value of the old tractor to the purchase price of the new tractor and figured the subsequent payments on the balance of the purchase price.

Because Brenda has an equity interest in the new tractor, she is treated as making an installment purchase of the new tractor. Her “lease” payments are treated as installment payments. She cannot deduct the payments as lease payments, but she can deduct the new tractor’s cost through § 179 expensing and/or depreciation. She can also deduct the interest portion of her installment payments.

✓ Observation

As discussed earlier in this chapter (see Example 5.11) prepaid lease payments can be deducted in full currently only if the benefit does not exceed 12 months. If a trade-in credit covers lease payments that extend beyond 12 months, only the portion attributed to months in the current tax year can be deducted currently.

Example 5.16 Trade-In Treated as a Sale

If Brenda from Example 5.15 sold her old tractor to the dealer for \$25,000, she must report her gain from that sale on Form 4797 as ordinary income that is not subject to SE tax. If her adjusted basis in the old tractor after depreciation is zero, she has a \$25,000 gain to report.

If the dealer applies the \$25,000 sale price to true lease payments, the \$25,000 can be deducted as a lease payment subject to the 12-month rule discussed earlier in this chapter. If the annual lease payments are \$25,000 or more, Brenda can deduct the \$25,000 credit as a lease expense in the year she entered into the lease. However, if the annual lease payment is less than \$25,000, she can deduct currently only the portion of the credit that is prorated to the tax year of the transaction.

Depreciation vs. Lease Expense

If the transaction qualifies as a lease for tax purposes, the next step is to consider whether a lease payment deduction is more beneficial than a depreciation deduction. If the asset qualifies for the §179 deduction (\$500,000 for 2011 and \$125,000 for 2012), the taxpayer can get a bigger first-year deduction by purchasing rather than leasing the asset. (The details of qualifying property and other considerations are discussed in Chapter 4.) Leasing may provide a larger first-year deduction for assets that do not qualify for the § 179 deduction, such as general-purpose farm buildings.

Furthermore, leasing may also be a useful tool for the taxpayer whose purchases are great enough to cause the phase-out of the § 179 deduction. (In 2011, the deduction is reduced dollar for dollar for total qualifying purchases over \$2,000,000.)

Example 5.17 Leasing to Maximize § 179 deduction

George plans to purchase \$2,200,000 of equipment in 2011. Because this exceeds the \$2,000,000 limit on qualifying property by \$200,000, his § 179 deduction is reduced by \$200,000 from \$500,000 to \$300,000. If he leases the \$200,000 of excess equipment, he could claim the full \$500,000 § 179 expense deduction. The leasing company told George that his first-year lease payment would be \$40,000.

The total deductions available to George for the two alternatives are shown in Figure 5.3

FIGURE 5.3 Deduction Alternatives

	<u>Purchase Only</u>	<u>Purchase and Lease</u>
§ 179 deduction	\$300,000	\$500,000
Lease payment	0	40,000
First-year depreciation*	<u>203,490</u>	<u>160,650</u>
Total first-year deductions	<u>\$503,490</u>	<u>\$700,650</u>

* 10.71% of cost of purchases reduced by § 179 deduction

George can increase his first-year deduction by \$197,160 if he leases the excess equipment that would reduce his maximum § 179 deduction.

Non-Tax and Other Considerations

Example 5.17 illustrates that using a lease may generate significant first-year tax deductions. Note that the lease payment in the example is \$40,000, whereas the depreciation expense on \$200,000 of equipment would be only \$21,420. However, the producer needs to consider the total cost of leasing versus purchase over the life of the asset. A lease may include a different interest component than the financing available for purchase. The purchase option amount must be factored in. The lease term may also be shorter than the loan term, making it necessary to consider the time value of money. In making the decision, the farm producer should consider a cash-flow analysis that takes into account all of these factors.

State income taxes, such as incentives for capital purchases, also influence the decision, and there may be non-tax considerations favoring the lease such as:

1. The lease obligation not being included as a financial statement liability,
2. No lost capital on the financial statement for the leased item, and
3. The ease of replacing leased equipment if it becomes obsolete or is no longer needed.

Summary

Because the federal income tax rates are graduated (a higher tax rate applies to income in the higher brackets than in the lower brackets) farmers who use cash-basis accounting can manage their tax liability by shifting income away from the high-income years and deductions away from low-income years. However, the tax rules impose some limits on making these shifts and there are some non-tax factors to include in the analysis of the costs and benefits of the shifts.