DON'T FORGET IRS' SHARE

WHEN A LEASE IS MORE

Written by Marcia Taylor

Ag lenders are promoting leasing as a way to help farmers get financially fit. Equipment dealers need to keep moving inventory in the midst of a farm recession. But the pressure to lease equipment also is exposing many farmers to credit misunderstandings and unexpected tax bills just at a time they can least afford to write the IRS a five- or six-figure check, warned some of the 200 attending an agricultural meeting of the American Institute of CPAs this week.

"Due to lower crop prices and economic conditions, farmers have been enticed to 'trade in' their fully depreciated equipment for a lease of new equipment," said Paul Neiffer, a CPA with CliftonLarsonAllen in Kennewick, Washington, and a conference instructor. Depending on the type of lease, this can result in unintended tax consequences to the farmer, Neiffer added, sometimes to the tune of $100,000 or more.

Jim Reeve, a manager for Latta Harris CPAs in Tipton, Iowa, counts half a dozen clients in the last few months who traded owned farm equipment for what turned out to be "operating" leases -- essentially tax lingo for lease-rentals with no bargain purchase price at the end of the lease term.

"The way they understood their machinery dealers, they thought they were trading equipment as a down payment on a lease," Reeve said. "They were surprised when we looked at the contracts and had to tell them, no, this wasn't a trade. It was a sale and they owed IRS for all their depreciation recapture in the year of the trade."

In a sale, a fully depreciated combine with a market value of $200,000 could trigger $70,000 in state and federal taxes, Neiffer estimated.

SHELL SHOCKED

Imagine the shock when a Pennsylvania farmer learned the damages from Mike Peachey, a CPA who heads ag services for Acuity Advisors and CPAs in Lancaster, Pennsylvania. His client understood he was trading owned equipment for a "capital" lease, one that simply financed the ultimate purchase of the new equipment. He expected to be able to use Sec. 179 depreciation to write off up to $500,000 on the new acquisition. Instead, Peachey interpreted the contract as an operating lease that triggered a surprise $100,000 tax bill. There was no immediate $500,000 write off, either.

The confusion stems from the complexity of lease contracts and the terminology that calls contracts leases when some are more like rentals and others resemble purchase contracts with built-in financing. "Failure to understand the differences can be catastrophic," Peachey said.

The problem is exacerbated by the fact that many operators fully depreciated farm equipment with Sec. 179 or bonus depreciation during the heyday of peak commodity prices. When they trade in the owned equipment for an operating (rental) lease, they trigger an immediate recapture of depreciation on the full market value of the equipment. "It's tantamount to a sale," Peachy added.

Here are examples Neiffer gave on why it pays to understand the type of lease you are signing.

CAPITAL LEASES

If a farmer enters into a capital lease, IRS treats this as a purchase of new equipment. The traded equipment is eligible for like-kind exchange treatment, generally resulting in no gain or loss, Neiffer said. However, since the transaction is treated like a purchase, the equipment is depreciable and the lease payments are not expensed.

Say Larry trades his three-year-old John Deere tractor worth $100,000 for a new S680 on a capital lease. The total present value of the lease payment is $400,000. Larry will recognize no gain on the transaction and have a depreciable basis of $300,000 in the new S680.

OPERATING/FINANCE LEASES

Larry trades in a three-year-old John Deere tractor worth $100,000 for a four-year operating lease on a new John Deere S670 combine. The tractor originally cost $200,000 and has been fully depreciated. Larry will owe regular income taxes on a gain of $100,000 this year but will be able to deduct a $25,000 lease expense each year for the next four years to partially offset this bill.

"In essence, the farmer will get to amortize the cost of the trade-in over the life of the lease, but it's a question of timing," Reeve said.

With so much confusion reigning over leases, CPAs highly recommend that clients ask for a lease review before documents are signed. That way, there will be no surprise tax bills post mortem.

Do farmers normally ask for tax advice before they make an equipment deal? "Heck no, it's usually after the fact," said Latta Harris' Reeve. "But we definitely need to get the word out. There will be a lot of this the next few years. Equipment dealers are starting to feel the sales slump and farmers need to reduce their costs."