

Transferring Ownership—Machinery

In many two-generation farming arrangements, the younger party begins by working for a fixed wage. Eventually, however, he or she will want to become an owner/operator not just an employee. Achieving this requires determining how control and ownership of farm assets will be distributed. Often this includes transferring control and ownership of some or all of the existing farm assets to the younger party.

Before transferring ownership of assets, both buyer and seller need to be familiar with income tax provisions concerning the transfer of the assets. Both parties must understand the tax consequences associated with Depreciation and the appropriate method to calculate depreciation; Recaptured Depreciation; Capital Gains and Losses; Gift Transfers; Imputed Gift Transfers; Interest & Principal Payments and Lease Payments.

I. Business Transfer Strategies

A. **Business Transfer Strategies involve transferring the overall operation and management of the business. The method chosen for transferring machinery and other asset ownership is often based on the strategy developed for transferring the entire business. Accordingly, the business transfer strategy should be developed prior to choosing a method of transferring machinery.**

B. **The Planning horizon for transferring machinery usually corresponds to the length of time the parties intend to farm together. Fast strategies transfer the business from the older party to the younger party quickly and completely at one point in time. Gradual strategies transfer the business over a period of years and are used when the two parties plan to farm together for an extended period of time.**

C. Fast Business Strategies

1. **Outright Sale, installment sale, gift, part sale/part gift are examples of some “fast transfer” strategies.**
2. **Younger party often cash rents land and facilities from older party, and the two parties develop a separate plan to transfer assets.**

D. Gradual Business Transfer Strategies

- 1. The two parties intend to farm together for a number of years.**
- 2. Younger party may join the business and form a *multi-person arrangement* or *spin-off* and create a separate business but still jointly own machinery or other assets with the older party.**
- 3. Methods of transfer include gradual sale, lease with option to buy, gradual sale with lease, gradual sale with gift and others.**

a) Multi-Person Operation

- (1) Older and younger parties farm together for a period of time. Usually, younger party initially buys a predetermined percentage of machinery and assets, such as 20%, 50% etc. When the older party retires, the younger party purchases the remaining share.
- (2) Where the parties plan to farm together only for a few years, they may develop a flexible business arrangement such as an enterprise operating agreement or a farm operating agreement.
- (3) Where the parties plan to farm together for many years, they may choose a more formal business arrangement, such as a partnership or corporation.
- (4) Remember, each time an asset is transferred a change in the percentage of the assets owned by each party occurs and results in a change in how income is divided.

b) Spin-Off Operation

- (1) The parties cooperate but farm separately. Younger party begins his or her own separate business with a separate land base.
- (2) Initially, both operations are farmed with one set of machinery that is owned by both parties. The parties may co-own each piece of machinery, or each party may own separate pieces of machinery.
- (3) Machinery may be owned in the same proportion land is farmed, which may eliminate the need to make payments between the parties for machinery use.
- (4) An arrangement may be developed where labor and machinery are traded between the businesses.

II. Objectives of Transferring Ownership

A. The method used to transfer ownership depends on the financial conditions and objectives of the parties involved. The following are typical asset transfer objectives.

- 1. Opportunity for younger party to gain an ownership interest in some assets**
- 2. Income Tax Considerations**
 - a) *Income tax liabilities of the seller, the older party, may be reduced by spreading the sale of assets over a period of years or through a gifting program.***
 - b) *Gifting may, however, reduce tax advantages of the person receiving the asset.***
 - c) *There may be tax advantages to both parties if the older party continues to hold highly appreciated assets until death.***
- 3. Cash Flow Considerations**
 - a) *Cash flow payments should be consistent with the buyer's, or younger party's, financial situation.***
 - b) *Spreading the sale or payments from the sale over a period of years may help the younger party meet cash flow requirements.***
 - c) *Consider possible financing options, such as third party financing, current savings, or seller financing.***
- 4. Equity Considerations**
 - a) *Consider the impact of agreements with or gifts to the initial child brought into the business on subsequent children who may be participating later. Consider varying ages and abilities of those who may eventually be included in the operation.***
 - b) *If assets are gifted to or otherwise favorably transferred to a farming son or daughter, consider whether you will make similar or equivalent provisions for non-farm children.***

III. Methods of Transferring Ownership

A. Outright Sale

- 1. Seller immediately transfers ownership, title, to the buyer and buyer, in exchange, immediately pays seller the full purchase price.**
- 2. Considerations**
 - a) *A younger or beginning farmer may find it difficult to generate sufficient cash to make an outright purchase of machinery.***

- b) *Third party lenders may be willing to loan funds if the machinery can serve as collateral or if the buyer has other assets that can be pledged.*
 - c) *Third party loans may require a co-signer if the borrower does not have sufficient net worth.*

B. Installment Sale

- 1. Buyer receives immediate possession of the machinery. Seller finances the sale for the purchaser and receives periodic payments according to a predetermined schedule.
- 2. Considerations
 - a) *Eases cash flow requirements on purchaser by spreading payments out over a number of years.*
 - b) *The parties can negotiate their own contract terms. Often the buyer receives more favorable loan terms, such as smaller down payment, lower interest rate, or longer repayment term, than would be available through a commercial lender.*
 - c) *Payment schedules can be tailored to match the income stream generated by the asset. For example, payments may be scheduled when crops are sold.*
 - d) *Seller does not have immediate use of the funds as compared to an outright sale. Additionally, the machinery may depreciate faster than the debt is repaid, thereby reducing the value of the collateral.*
 - e) *The payment schedule should specify the interest rate to be paid on the unpaid balance and indicate whether the rate is fixed for the life of the contract or will be periodically renegotiated.*

C. Gradual Sale

- 1. The line of machinery is transferred by selling one or two items outright each year. A plan should be developed that identifies which items will be transferred each year and how many years will be needed to complete the desired transfers. The assets transferred each year must be clearly specified. The buyer is responsible for repairs, insurance and other ownership costs associated with each piece of equipment when he or she takes possession of it.
- 2. Considerations
 - a) *If the parties are farming together, the gradual transfer will change how farm income is divided each year. Because the younger party will own more business assets each year, he or she should receive an increasing share of income.*
 - b) *If the older party has already left the business, the younger party will need to lease items that have not yet been purchased.*

- c) *The younger party's cash requirements are spread out over a number of years but the gradual sale does not require the buyer to borrow funds to purchase the entire equipment line at once.*
- d) *The number of items transferred in a particular year can be adjusted to reflect current cash flow needs.*
- e) *Some sellers transfer ownership each time a major piece of machinery is replaced. The buyer may provide down payment money for the trade and pay the seller the fair market value of the item traded. If the parties want a co-ownership situation, the fair market value of the item traded is counted toward the seller's obligation for the new machine.*

D. Leasing

1. Lease arrangements can be used where the owner has already left the business but the machinery ownership has not been transferred. A lease arrangement can be used until the machinery is purchased. Lease payments should be reasonable and cover the owner's fixed costs of depreciation return on investment. The renter is usually responsible for all costs related to use, such as fuel, lubrication, repairs, and maintenance. The owner is usually responsible for paying for capital improvements, such as major overhauls or engine replacement.

2. Considerations

- a) *Capital improvements increase the value of the machine, the rental rate and the eventual sale value.*
- b) *In the absence of capital improvements or machine replacement, rental payments should decrease as the machinery ages.*
- c) *When both owner and renter are using a machine, lease payments can be calculated by the acre or by the number of hours the equipment was in use.*
- d) *Lease arrangements are often combined with transfer options previously described.*

E. Lease with Option to Buy

1. Leasing with an option to buy enables the younger party to use equipment for a number of years and then purchase it at the end of the lease period.

2. Considerations

- a) *Leasing machinery can lower the cash requirements of the younger party during initial farming years.*
- b) *The extended time period allows the younger party to accumulate financial resources and develop greater certainty regarding the direction the operation will take prior to purchasing.*

c) The lease with option to buy must be properly structured to avoid treatment as an installment sale.

F. Lease with Gradual Sale

1. Each year the younger party purchases one or more items of machinery and leases the machinery that has not yet been purchased. As items are purchased they are removed from the lease agreement and the lease payment is correspondingly reduced.

G. Gifting

1. The older party may make an outright gift of the machinery line or individual pieces of machinery to the younger party.

2. Considerations

a) The older party, or gift giver, receives no payment from the younger party, or gift recipient, in exchange for the machinery.

b) Gifting programs may be financially advantageous to the recipient. However, if the older party needs money for living expenses or other financial commitments it may cause current financial hardship or reduce financial security in retirement.

c) Gifting programs should be coordinated with current IRS gift tax rules and exclusion amounts. Carefully document the value of gifted items.

d) Evaluate the impact gifts may have on relationships with other family members. Will others feel they have been fairly treated? Are there legitimate reasons for treating individuals differently?

H. Combination Gift & Sale

1. Machinery gifts can be combined with an outright sale. The value of the gift is the difference between the fair market value of the machinery and the amount of cash paid by the buyer.

I. Gradual Gift & Sale

1. A gradual sale of machinery may be combined with a gift. The sale price is below the fair market value of the equipment. The value of the gift is the difference between the purchase price and the fair market value.

IV. Worksheets for Assessing Machinery Transfer

A. Before any assets are transferred, several steps must be completed.

1. First, prepare a written inventory of the assets to be sold or leased. See the Asset Inventory form below.

a) Once the assets are inventoried divide them into three groups:

- (1) Items the owner will retain
 - (2) Items the buyer will acquire
 - (3) Items that will be disposed of by private sale, auction or trade
2. Determine and record the terms for assets that are to be transferred. If an item is to be sold, record the sale price and payment schedule. If the sale is below fair market value record the gifted amount. If assets are leased record the rental rate and payment schedule.
3. Once adjusted tax basis is determined and sale price agreed on, potential income tax consequences can be determined. Completing the Sale of Depreciable Assets form will help you determine how and in what order to transfer depreciable assets.

Asset Inventory

Equipment Description	Estimated Current Value	Original Tax Basis	Last Adjusted Tax Basis	Expected Sale Price	Rental Rate if Leased

Sale of Depreciable Assets

Equipment Description	Capital Gain	Recaptured Depreciation	Capital or Ordinary Loss	Tax Due

Total

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