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White paper

Farm equipment, depreciation and tax law

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Several provisions in the new tax law will affect decisions farmers make when they lease, buy or sell farm equipment, livestock and other farm property.

Depreciation

Farmers generally get to deduct the cost of most items of tangible property that they use in their farm operations. Some items are immediately deductible, while other items that have a longer useful life, are deducted over the life of the item through the concept of depreciation.

Modified Accelerated Cost Recovery System (MACRS)

The Internal Revenue Service (IRS) has developed specific rules on depreciation, providing depreciation methods, as well as dividing assets into specified classes with corresponding useful lives for the asset. The MACRS is used to recover the basis (cost) of most business property and consists of two depreciation systems — the General Depreciation System (GDS) and the Alternative Depreciation System (ADS).[i] GDS is used unless required by law to use ADS.[ii] The GDS includes three depreciation methods — 200% declining balance (DB), 150% DB and straight line.

The GDS and ADS also consist of asset classes that provide useful lives over which the property can be depreciated. Prior to the new tax law, farm equipment and certain other farm assets, such as fencing and grain bins, had seven-year lives. Farm buildings had longer lives of either 10 or 20 years, depending on their use and land improvements (drain tiles and berms, for example) and could be depreciated over a 15-year period.[iii] Single-purpose agricultural or horticultural structures, and any tree or vine bearing fruit or nuts are assigned a recovery period of 10 years. A few items, such as breeding stock had three- or five-year lives.

Under prior law, all farm property (except real property) was generally required to use the 150% DB method, though straight line depreciation could be elected. Trees or vines bearing fruit or nuts used the straight-line method. Under the new tax law, the 150% DB method is no longer required for property used in a farming business (other than 15-year or 20-year property).

The new tax law also shortens the recovery period from seven to five years for any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) used in a farming business. This treatment applies to new property placed into service after December 31, 2017.

Section 179 and bonus depreciation

In addition to MACRS, the IRS added two additional depreciation provisions — Internal Revenue Code ("Code") section 179 and section 168(k) bonus depreciation. Both provisions allow for accelerated depreciation pursuant to certain rules. The new tax law modified these rules allowing for immediate deduction of even larger amounts in the short term.

In 2017, Code section 179 allowed an immediate deduction on purchases of up to $510,000 of depreciable items. Beginning in 2018, purchases of up to $1 million may be fully depreciated in the year of purchase.[iv] The Code section 179 deduction had a phase-out threshold of $2,030,000 in 2017. The limit for 2020 is $1,040,000 and $2,590,000 for total equipment purchases. Amounts exceeding $2,590,000 will see the deduction beginning to phase out, with no deduction available for amounts over $3,630,000. At that point, no deduction under Code section 179 would be allowed.

Even if the taxpayer couldn't deduct the entire cost of an item under Code section 179, he might be able to pick up the difference with bonus depreciation. In 2020, a taxpayer could use bonus depreciation with respect to 50% of the cost of new assets. Under the new tax law, most farm items[v] placed into service after September 27, 2017 and before January 1, 2023 are entitled to 100% depreciation in the first year.[vi] This includes plants bearing fruits and nuts if planted or grafted before/after those dates. Bonus depreciation then phases out over the next four years as follows:

- Placed into service in 2023 – 80%
- Placed into service in 2024 – 60%
- Placed into service in 2025 – 40%
- Placed into service in 2026 – 20%
- Placed into service in 2027 and thereafter – 0%

Normally, the taxpayer would take the Code section 179 deduction first and then turn to bonus depreciation, if necessary. While bonus depreciation is at 100%, the ordering of the provisions will not matter. Once the bonus depreciation phase out applies, any remaining depreciation after taking the Code section 179 deduction would use the GDS system described above.

An additional change made by the new tax law to these deduction provisions is that both Code section 179 and bonus depreciation apply to new and used purchases placed into service by the farmer. Under prior law, purchases had to be of "new" equipment.

Example	
Equipment purchased	$1,250,000
Section 179 dedcution (max. amt. for 2020)	-$1,000,000
Bonus depreciation	-$250,000
Tax savings as a result of full depreciation (assuming top 37% tax bracket)	$462,500

Under straight-line depreciation, the farmer would deduct $250,000 a year over five years.

100% depreciation in the first year with bonus depreciation applies automatically, unless the taxpayer elects otherwise. If a farmer makes a large equipment purchase in a year in which he will have limited reportable income against which full depreciation can be used, he may want to stretch the deductions out by electing to use the normal MACRS recovery periods.

Sale of farm equipment

Like-kind exchanges and expensing

The flip side of depreciation deductions is that they reduce the owner's basis in the property to $0. This means that if the property is sold, the owner would normally recognize a taxable gain on the sale due to depreciation recapture under Code section 1245. Because of this unwelcome result, many farmers would have used the like-kind exchange rules found in Code section 1031 to defer the tax on the sale prior to 2018. They would trade in a piece of farm equipment for a newer model or trade livestock for other livestock. The basis of the old property would carry over to the new property and taxation on any gain would be deferred until the replacement property was sold.

The new tax law changed Code section 1031 so that it now applies only to real property. Therefore, as of January 1, 2018, there can no longer be 1031 exchanges for any form of personal property, such as equipment and livestock.

Another option to dispose of used property

If the taxpayer hopes to avoid paying tax on the sale of used property, he could set up a charitable remainder trust to which he donates the property. The trust pays a certain amount of specified income to a designated beneficiary (which can be the farmer or whoever else the farmer names as the beneficiary) until the trust is terminated. Upon termination, any remaining assets in the trust go to the charity designated by the farmer. This remainder interest for the charity must be projected to be at least 10% of the value of the trust's original value.

Generally, the trust would sell the donated asset and then invest the proceeds in stocks, bonds, mutual funds or some other asset. Any distributions to the farmer would be taxable to him, but the use of the trust allows him to spread the taxation over a number of years instead of all in one year.

It is a good idea for the trust to avoid a targeted sale of the property to a family member or neighbor.

Instead, the property should be subject to an independent sale, such as at public auction.[vii] Because the property is fully depreciated, there is generally no charitable deduction when the farmer donates the property to the trust.

Self-employment tax and depreciation

Depreciation deductions are taken on IRS Form F and thus are deductible for both income and self-employment tax purposes. If the farmer sells a piece of farm equipment and is taxed on the proceeds as Code section 1245 depreciation recapture, the recaptured amount, while taxable as ordinary income, is not subject to self-employment taxes.

Conclusion

While the revised depreciation rules found in the new tax law will allow full and immediate depreciation deductions for purchases over the next several years, the loss of like-kind exchange treatment of personal property will impact taxation of these assets on the back end. From a tax standpoint, farmers will now need to think more strategically when buying and selling farm equipment and other farm items.

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[i] IRC section 167 and 168; IRS Publication 225 – Farmer's tax guide.
[ii] *Id.*
[iii] Depreciating Farm Assets, Successful Farming at Agriculture.com, Mike McGinnis, 1/9/17.
[iv] The $1 million will be indexed for inflation.
[v] Those with a recovery period of 20 years or less.
[vi] Code section 168(k).
[vii] Ask the Taxman: Can CRT be used to dispose of farm machinery? Andy Biebl, agfax.com, July 7, 2014.