CFAES

PLANNING FOR THE FUTURE OF YOUR FARM

Legal tools and strategies for farm transition and estate planning

RETIREMENT FROM FARMING: STRATEGIES FOR TRANSFERRING FARM OPERATING ASSETS

Robert Moore, Attorney, OSU Agricultural and Resource Law Program
Zachary Ishee, Law Fellow, National Agricultural Law Center

Retirement means different things to different farmers. For some, retirement is the gradual process of turning over the farming operation to the next generation. For others, retirement may be the immediate sale of operating assets when there is not an heir to take over the farming operation. Regardless of the type of retirement, operating assets will often be transferred. This publication discusses the different strategies to transfer operating assets and the implications of each strategy.

THE TAX ISSUE

Most farmers are aware of the tax bill that is awaiting them upon retirement. This tax liability is primarily attributable to two causes. First, farmers typically delay the sale of grain and other assets into the next tax year. Additionally, inputs may be pre-purchased in the current tax year to help manage income. So, upon retirement, there may be an entire year or more of products to sell with few or no expenses to offset the sale.

Second, and the focus of this article, the sale of operating assets will likely trigger significant taxes. Assets sold at retirement usually include gains taxed at capitals gains rate or depreciation recapture taxed as ordinary income. The extent of the tax liability upon selling operating assets may be underestimated by retiring farmers due to the uniqueness of the situation. While it may not be realistic to avoid all adverse tax consequences, some strategies can be implemented to at least reduce the negative tax impacts on the retiring farmer.

In order to determine the tax liability issues of selling operating assets, it is important to understand the concept of depreciation recapture. At a basic level, depreciation recapture is the mechanism the IRS uses to recoup taxes an individual legitimately avoided by depreciating the value of an asset

This work is supported by the National Agricultural Library, Agricultural Research Service, U.S. Department of Agriculture. It is provided for educational purposes only, is not legal advice, and is not a substitute for the need to consult with a competent attorney licensed to practice in the appropriate jurisdiction.

over its lifespan or expensing it upon purchase. The owner is liable for the income generated by the sale of an asset in excess of its tax basis. The sale of these assets, known as IRC Section 1245 assets, often triggers substantial depreciation recapture.

The following two examples are illustrations of how depreciation recapture works.

> **Example 1:** Farmer buys a tractor for $200,000. He has taken $150,000 of depreciation on the tractor. He sells the tractor for $100,000. Farmer will owe ordinary income tax on $50,000, the difference between the sale price and the remaining tax basis after depreciation.
>
> **Example 2: Recapture.** Farmer buys a tractor for $200,000. He elects Section 179 and expenses the entire purchase price in the year of purchase. Farmer then sells the tractor for $100,000. The sale of the tractor will create $100,000 of depreciation recapture taxed at ordinary income tax rates.

CAPITAL GAINS: A LESSER PROBLEM

Some capital gains could also be incurred upon retirement, but capital gains are usually less of an issue than depreciation recapture. For example, a retiring dairy farmer will likely pay capital gains on the sale of the raised cows, rather than depreciation recapture. Generally, capital gains are preferred to depreciation recapture as capital gains tax rates tend to be lower.

While a retiring farmer does usually not sell land, land is worth mentioning. Land does not depreciate so there will not be depreciation recapture. If land is sold for more than its tax basis then capital gains tax will be owed on the gain. However, land improvements such as buildings and bins can be depreciated and thus may be subject to depreciation recapture.

> **Example 3.** Farmer bought a 100-acre farm for $500,000. Farmer paid $450,000 for the land and $50,000 for a general purpose building on the farm. Farmer depreciated the building to a $0 tax basis but could not depreciate the land. Several years later, Farmer sells the farm for $800,000 with $40,000 of the sale price allocated to the barn. Farmer will pay depreciation recapture of $40,000 on the barn. Farmer will also pay capital gains on $310,000, the amount the sale price allocated to the land exceeds the tax basis (purchase price).

STRATEGIES TO TRANSFER ASSETS

There are no perfect solutions for transferring operating assets upon retirement, but there are strategies that can accomplish the farmer's goals and address tax issues. The following discusses seven asset transfer strategies and the advantages and disadvantages of each strategy. Determining the best strategy requires weighing the advantages and disadvantages on a case-by-case basis.

Strategy 1: Gifting

The gifting of assets is the simplest transfer strategy. Gifting works best when the assets are being transferred to a family member and the retiring owner does not need income from the assets. Even large gifts of assets might not cause gift taxes if the amount of the gift is less than the owner's remaining federal estate tax exemption. However, gifting may not be the best tax strategy as there are significant benefits of inheriting assets upon the owner's death rather than receiving them as a gift during the owner's lifetime.

Advantages. The biggest advantage of gifting is the simplicity of the transaction. For most farm operating assets, which are usually untitled, transferring the assets has almost no transactional cost and is quite simple.[1] For example, a tractor can be gifted by simply signing an acknowledgement that includes a description of the asset gifted, the person receiving the gift, the value of the gifted asset and the date transferred. The simplicity of gifting allows for the gift to occur quickly and at any time.

Another advantage of gifting and any similar strategy that transfers ownership is that the liability associated with the property is transferred to the new owner. This allows for the former owner to immediately eliminate their liability for the transferred assets. Strategies that include retaining ownership, such as leasing, cause continuing liability exposure to the owner. For the retiring farmer, the less liability exposure, the better.

Last, gifting can enhance the likelihood of the next generation having a viable farming operation. The fewer assets the next generation farmer must purchase, the more likely they are to have financial viability. Many retiring farmers place a high degree of importance on passing on a viable farming operation to the next generation.

Disadvantages. Gifting includes negative aspects to consider. The obvious drawback is that the owner does not receive any compensation for the asset. Gifting is not a good strategy for those retiring farmers who need to generate income from the sale or lease of assets.

Another disadvantage of gifting is the loss of potential stepped-up tax basis. When someone dies, the assets they owned receive a new, stepped-up tax basis equal to the value of the asset at the time of their death. The person receiving the deceased person's asset can then re-depreciate the asset or sell the asset for little or no gain, and therefore no tax. A stepped-up basis is valuable to the person who receives the asset. With all other things being equal, it is usually better to receive an asset through inheritance than through gifting.

> **Example 4.** Farmer decides it is time to retire and allow Daughter to take over the farming operation. Farmer has adequate retirement income so that he does not need income from his machinery. He owns machinery with a fair market value of $600,000 and no remaining tax basis, so the machinery is fully depreciated. Farmer gifts all the machinery to Daughter.

[1] For titled assets such as trucks, trailers and real estate, title must be transferred to the person receiving the gift before the gift can be completed.

Farmer's gift to Daughter will not cause gift taxes. His federal estate tax exemption will be reduced by $600,000, the current value of the machinery. Daughter will receive no tax basis in the machinery and thus is not permitted to depreciate the assets and if she sells the assets, she will incur depreciation recapture taxes.

Timing is an important factor to consider in the gifting strategy. While it is true gifting assets forfeits the stepped-up tax basis, the retiring farmer may not want to wait until death to transfer the assets. In the above example, if Farmer is 70 years old, he could easily live another 20 years or more. It may not be feasible or desirable to keep the assets until death and gifting may be the best strategy. As stated previously, there is no perfect solution to transferring assets.

Gifting can also be done on a gradual basis. Instead of gifting all the assets at one time, gifts can be made each year until all the assets are transferred. If each annual gift is less than the annual gift exclusion, currently $18,000/year, there are no gift taxes owed and the gift does not reduce the federal estate tax exemption.

For a more detailed and thorough discussion of gifting, see *Gifting Assets Prior to Death*, a law bulletin available at farmoffice.osu.edu.

Strategy 2: Outright Sale

When the owner needs income from operating assets, an outright sale may be the best transfer strategy. An outright sale involves all assets being transferred simultaneously with a payment for the entire sale .Because many operating assets are untitled, an outright sale can be completed rather easily. The owner should sign a bill of sale identifying the property, the purchase price, and date of sale. The buyer provides the funds, and the sale is completed. For any titled assets, the title must be transferred to the buyer to complete the sale.

Advantages. The obvious advantage of a sale is that it creates income. The purchase price can be any amount agreed to by the seller, including discounted purchase prices for family or friends. In a true outright sale, the owner receives the entire purchase price when the equipment is transferred to the buyer.

A second advantage is that the sale transfers title and relieves the seller of the liability of owning the assets. Less machinery and equipment means the retiring farmer has less potential liability. Selling equipment is a good strategy to reduce liability exposure.

Disadvantages. The primary disadvantage of a sale is the tax liability. As discussed previously, selling operating assets will typically trigger significant taxes including depreciation recapture. Taxes can easily consume 40% or more of the sale proceeds. To avoid surprises, it is advisable to have an accountant calculate the taxes that will be incurred with an outright sale.

Another disadvantage with an outright sale is that it can consume much of the next generation's resources and capital. If the next generation purchases the retiring generation's assets, there is less capital available to grow and expand the farming operation.

Strategy 3: Gradual Sale

Instead of an outright sale, assets can be sold gradually, over time. In this strategy, a few items are sold each year until all assets have been transferred. The sales can occur uniformly each year or be adjusted as the seller needs income or the buyer has available resources for purchases.

Advantages. While a gradual sale does not avoid the depreciation recapture issue, it can help keep the seller in a lower tax bracket. Instead of one large sale that can move the seller into higher tax brackets, the sales can be managed to prevent income from reaching the higher tax levels.

A gradual sale is also relatively simple. It is the same process as the outright sale except it is done each year. The seller must determine the assets they wish to sell each year, guided in large part by tax liability and income needs.

Disadvantages. The biggest disadvantage with the gradual sale is that the seller must wait on being paid the full value of the assets and the seller retains ownership of the unsold assets. If the seller needs a large amount of sale proceeds initially, the outright sale may be a better strategy. Also, if the seller does not wish to retain any ownership of the assets, an outright sale may be the better option.

Strategy 4: Installment Sale

According to the IRS, an installment sale is a sale of property where at least one payment will be received after the tax year in which the sale occurs. The terms of an installment sale can vary greatly, and the parties involved have discretion to develop terms that are mutually agreeable. An installment sale spreads the payments over a number of years and may seem like an obvious method to spread out depreciation recapture and capital gains. However, an installment sale is often the worst strategy when selling operating assets. That's because the IRS requires all tax liability due from depreciation recapture to be paid in the year of the sale.[2] Farmers who are not familiar with this rule can find themselves in a difficult situation if they attempt to sell operating assets through an installment sale. The tax due in the first year may exceed the first payment they are to receive.

Example 5. Farmer owns $500,000 of farm machinery and has decided to sell all the machinery at the end of 2024. Farmer sells the machinery to his neighbor and allows the neighbor to pay for the machinery over five years. Farmer is scheduled to receive $100,000 plus interest each year, for five years, beginning December 1, 2025.

While preparing his taxes for the 2024 tax year, Farmer discovers that all the depreciation recapture tax is owed in 2024. The total tax liability is equal to $150,000, significantly more than the first payment. Farmer files his taxes on March 1, 2025, owing $150,000 in depreciation recapture but having received only $100,000 plus interest in payments for the machinery. Farmer must use funds from another source to pay the tax on the sale of the machinery.

[2] Any capital gains can be spread out and are only due as payments are made.

As the above example illustrates, installment sales can cause a significant negative cash flow. Generally, installment sales should be avoided when selling operating assets. Either a gradual sale or a lease/option can spread out the payments without triggering a large, up-front depreciation recapture tax liability.

Advantages. An installment sale does transfer ownership to the buyer so that the seller has no further liability for the sold asset. Also, after the initial depreciation recapture is paid, much of the remaining sale proceeds may have little or no tax liability.

Disadvantages. As stated above, the primary disadvantage is that all depreciation recapture will be due in the first year of sale. Additionally, the seller always accepts the risk that the buyer does not make some or all of the installment payments. This risk can be somewhat reduced by the seller placing a lien on the purchased assets, but a lien cannot eliminate all risk of payment default.

Strategy 5: Lease with Purchase Option

A lease allows payments to be spread over the term of the lease with taxes due upon receipt of each payment, rather than all taxes due up front. The person leasing the machinery can then be given the option to purchase the machinery upon the expiration of the lease. For the retiring farmer who needs income from their machinery, this is a strategy worth exploring.

It is important to make sure this strategy is structured in a way that will not result in a sale classification. The IRS can and does scrutinize lease and option strategies to ensure they are not simply disguised sales. A practical step to help avoid classification as a disguised sale is to have separate documents for the transaction - a lease document and an option document. The following tips can also help to avoid a sale classification:

- Inclusion of a termination clause in the lease;
- The lease term is for less than the remaining economic life of the machinery;
- Lessee is not required to renew the lease for the remaining economic life of the machinery;
- Any option to renew is for more than nominal value; and
- The option to buy at the end of the lease is for more than nominal value.

If the IRS determines a lease with purchase option to be a disguised sale, the sale will trigger depreciation recapture and potentially interest and penalties. To avoid adverse consequences, be sure the transaction is a true lease with an option to purchase at the end of the lease.

The Lease

Advantages. The main advantage of the leasing strategy is that the tax liability is spread out over time. This provides a distinct advantage over an installment sale transaction that forces all depreciation to be recaptured in the year of the sale. Additionally, allowing the lessee to spread out their payments through a lease can help alleviate cash flow strains. The lease payments are a fully deductible expense for the lessee.

Disadvantages. There are three primary disadvantages of the leasing strategy, all related to ownership. First, the retiring farmer must retain ownership of the machinery. The owner could still

be liable for any damage or injury that arises from the machinery since they continue to hold ownership of the asset throughout the term of the lease. The liability of ownership can be minimized through insurance, favorable provisions in the lease, and using a formal business entity, but the liability cannot be eliminated entirely.

The second disadvantage is the lessee does not own the machinery during the term of the lease. Thus, the leased assets cannot be used as collateral and are not assets on the lessee's balance sheet. In fact, the lease obligations are a debt that may reduce the lessee's net worth.

Last, it can be challenging to determine lease rates for each year of the lease and to accommodate sales, trades, or additions of machinery. During the term of the lease, the owner may wish to sell a piece of machinery rather than make repairs. Or the owner may wish to trade older machinery for newer machinery. The lease needs to address the possibility of a changing inventory and include a mechanism to adjust the lease rates and other related terms. A pre-established, fixed rental rate will not work well unless the machinery inventory does not change during the term of the lease.

The lease should be drafted in consultation with an attorney. An experienced attorney can provide advice on important terms to include in the lease. A well drafted lease can help defer some of the liability of asset ownership and ensure the lease is flexible and adaptable to any changes in asset inventory.

The Option

Advantages. The Option allows the owner to delay the sale of the machinery for some number of years. At the end of the term of the lease, the machinery will have a lower value and thus create less tax liability for the owner. Also, the option defers depreciation recapture until the option is exercised. The sale of the machinery via the option can create a significant one-time payment to the retiring farmer.

Disadvantages. As stated above, the option does not cause ownership to be transferred until the machinery is purchased after the lease expires. The lessee will make lease payments for several years without gaining any equity. The option agreement should be a separate document from the lease agreement. The purchase price of the machinery must be reasonable and cannot be a de minimus amount, such as $1.

> **Example 6.** Farmer owns machinery valued at $500,000. Daughter is taking over the farm and will require the machinery for her farming operation. Farmer needs income from the machinery but wants to spread out payments over several years to minimize income taxes. Farmer and Daughter agree that Daughter will lease the equipment for seven years paying $40,000 per year. The lease payment will be adjusted for any change in inventory. At the end of the lease, Daughter has the option to purchase the machinery at the then appraised value of the machinery.

This lease and option strategy will allow Farmer to receive $40,000/year in income for seven years. Income tax will be incurred as each payment is received. Daughter can fully deduct the lease payment. At the end of the lease, if Daughter elects to purchase, Farmer will receive an

additional payment, but it will likely be significantly less than the original $500,000 value of the machinery.

Gifting Instead of Selling at Lease End

At the end of the lease, the retiring farmer can gift the assets to the lessee. However, this cannot be contracted for or included in the lease. There must be no obligation to gift the machinery at the end of the lease or the transaction will likely be considered a disguised sale. The gifted asset is received by the giftee with no increased tax basis because all previous payments were lease payments, not purchase payments.

> **Example 7.** Continuing the prior example, at the end of the lease Farmer decides he has adequate income and does not need Daughter to purchase the machinery. Farmer gifts the machinery to Daughter. The value of the gift is applied to Farmer's estate tax exemption, so no gift tax is owed. Daughter receives the machinery with $0 tax basis.

Strategy 6: Integrating a Business Entity into the Transfer Plan

Using a business entity such as a limited liability company (LLC)[3] for the transfer of operating assets can have multiple benefits. An LLC can reduce liability exposure, simplify the transfer process, and reduce tax liability. Anyone transferring operating assets should consider incorporating an LLC into the process.

The Process

An LLC must be registered with the appropriate state authority, usually the secretary of state. Then, documents such as an operating agreement and ownership certificates should be drafted. An attorney should assist in establishing the LLC to be sure all benefits and protections are available to the owner(s).[4]

After the LLC is created, all assets intending to be transferred must be assigned to the LLC. Non-titled assets such as machinery, grain, and livestock can be transferred by executing an assignment document. The assignment should include a description of each asset, the value at the time of transfer, and the date of transfer. Titled assets, such as trucks and trailers, can only be moved to the LLC by transferring the title to the LLC.

Caution should be used with assets that carry debt. In some situations when an asset's debt exceeds its tax basis, transferring to an LLC can trigger a taxable event. Be sure to consult with a tax advisor before transferring assets to an LLC to ensure no unexpected tax liabilities arise from the transfer.

[3] Several different types of entities can be used to transfer assets. LLCs tend to be the entity of choice for new businesses. For more information on business entities, see the *Structuring Your Farm Business* series at farmoffice.osu.edu

[4] For more information on establishing an LLC, see the *Starting, Organizing and Managing an LLC for a Farm Business* bulletin at farmoffice.osu.edu.

After the assets are transferred to the LLC, ownership can then be transferred to the future owner(s). Transferring LLC ownership is simple, often using ownership certificates for the transfer. The certificates identify the current owner, the amount of ownership being transferred, and to whom the ownership is transferred. In addition to the ownership certificate, the value of the ownership being transferred should be documented for tax records.

> **Example 8.** Farmer wants to transfer his farm machinery to Daughter in five, yearly installments. Farmer sets up an LLC and transfers the farm machinery to the LLC. Farmer initially owns 100 ownership units in the LLC. For each of the five years following the establishment of the LLC, Farmer transfers 20 ownership units to Daughter by executing ownership certificates. Farmer also documents the value of the ownership at the time of transfer. After five years, Daughter owns all 100 ownership units in the LLC.
>
> Alternatively, Farmer would like to transfer the entire ownership of the LLC immediately but be paid over five years. Farmer transfers the 100 ownership units and Daughter executes a promissory note agreeing to pay farmer in five annual payments. Daughter owns 100% of the LLC immediately but is able to pay for the purchase over five years.

The sale of LLC ownership is typically treated as a capital sale and thus is subject to capital gains. Therefore, tax is only owed on each payment in the year of the receipt rather than all taxes due in the year of sale. Additionally, the capital gains tax rate may be lower than the income tax rate of depreciation recapture. In some situations, ordinary income tax may be due on some part of the purchase price. Be sure to consult with a tax advisor, as the rules on the sale of LLC ownership can be complicated depending upon the timing and assets held by the LLC.

An LLC can also be used as part of the leasing strategy. Assets can be transferred to an LLC and then leased by the LLC. The LLC will provide at least some liability protection for the owner.

Advantages. Using an LLC has two primary advantages. First, the LLC provides additional liability protection for the owner(s). Second, the sale of the LLC interest is generally treated as capital gains tax which spreads out the tax liability and may keep the income taxed at a lower rate.

Disadvantages. One disadvantage of using an LLC is the set-up costs. Costs to establish an LLC and transfer assets can range from several hundred to several thousand dollars. Another disadvantage is the additional management requirements of an LLC. Each entity must have its own bank account, accounting, and tax return.

Strategy 7: Charitable Remainder Trust

A Charitable Remainder Trust (CRT) can be an excellent strategy for the retiring farmer to sell operating assets without immediate tax liability, receive a long-term flow of income, and make a charitable contribution. The strategy involves establishing a charitable trust, transferring operating assets to the trust, then selling the assets through the trust. Due to the charitable nature of the CRT, no tax is due upon the sale of the assets. The CRT then establishes an annuity for the retiring farmer

which generates annual income. At the termination of the CRT, the remaining principal in the CRT is donated to the charitable beneficiary. The CRT strategy is the most complicated strategy and will require the most legal and accounting fees.

A CRT is usually used when there is no farming heir, and the retiring farmer wishes to maximize potential income. For a detailed discussion of the CRT strategy, see the *Charitable Remainder Trusts as a Retirement Strategy for Farmers* bulletin available at farmoffice.osu.edu.

USING A COMBINATION OF STRATEGIES

Sometimes, a combination of strategies can work well. For example, the retiring farmer could gift some of the machinery and sell some of the machinery. A combination of strategies can provide the necessary income to the retiring farmer, minimize tax liability, and allow for a manageable cash flow for the next generation farmer.

> **Example 9**. Farmer determines he needs $200,000 from his machinery to fund his retirement. His machinery is valued at $500,000. Farmer sells one-half of the machinery to Daughter and, after taxes, receives $200,000. Farmer gifts the other one-half of the machinery to Daughter. Daughter is able to obtain a loan for the $200,000 purchase using the $500,000 of equity in the machinery. Farmer has used a combination of sale and gift strategies to transfer the machinery to Daughter.

CONCLUSION

There are several strategies for transferring farm operating assets at retirement. There is no perfect strategy, but each one has advantages and disadvantages. A thorough analysis of the implications on income, taxes, liability risk, and cash flow should be performed before deciding on the preferred strategies. Working with knowledgeable tax and legal counsel can help with the decision-making process and reduce the risk of unwanted or unexpected outcomes.

Find all our **Planning for the Future of Your Farm** resources at https://go.osu.edu/farmplanning

We completed this project with the generous financial support of the **USDA National Agricultural Library** and the **National Agricultural Law Center**, in partnership with **OSU Extension.**

farmoffice.osu.edu

@OhioAgLaw

moore.301@osu.edu

@OhioAgLaw

THE OHIO STATE UNIVERSITY
COLLEGE OF FOOD, AGRICULTURAL, AND ENVIRONMENTAL SCIENCES