Purchasing versus Leasing Farm Equipment

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Overview

The decision to lease or buy farm equipment is an important one with potential impacts on a farmer's bottom line. Historically, the traditional approach has been to buy farm equipment, but leasing is becoming a more popular approach. Understanding how leasing works—and the income tax implications that come with it—is vital for farmers seeking to make well-informed decisions that support their operational efficiency and long-term financial strategy.

Benefits of Leasing

Leasing, as an alternative to buying, does provide certain benefits. The major ones include lower upfront costs which allow more funds to be used in other aspect of the farming business; the ability to use newer equipment and the associated technology sooner; fixed leased payments (which can help with budgeting and cash flow); flexibility in deciding whether to continue with the same piece of equipment at the end of the lease term or changing to a different model; minimization of maintenance issues; and potential tax advantages.

Note: Of course, the leasing/buying issue is not an issue for some farmers. This is particularly true for smaller operations with a practice of using farm equipment for many years and for farm businesses that have sufficient cash reserves.

Structure of Farm Equipment Leases

Capital lease. The tax treatment of lease payments differs significantly between operating leases and capital leases, impacting a farmer's taxable income and overall financial picture.

A capital lease is a lease in which the only thing that the lessor does is finance the "leased" asset, and all other rights of ownership transfer to the lessee. The asset is the lessee's property and, for accounting purposes, is recorded as such in the lessee's general ledger as a fixed asset.

A transaction that is a capital lease has one of the following features (according to the Financial Accounting Standards Board):

- Ownership of the asset shifted from the lessor by the end of the lease period; or
- The lessee can buy the asset from the lessor at the end of the lease term for a below-market price (i.e., that the lessee is reasonably expected to exercise); or
- The lease term is at least 75 percent of the estimated economic life of the asset (and the lease cannot be cancelled during that time); or
- The value of the minimum lease payments (discounted to present value) required under the lease equals or exceeds 90 percent of the fair value of the asset at the time the lease is entered into; or
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

For a capital lease, the present value of all lease payments is considered to be the asset's cost which, as noted above, the lessee records as a fixed asset, with an offsetting credit to a capital lease liability account. For accounting purposes, as each lease payment is made, the lessee records a combined reduction in the capital lease liability account and a charge to interest expense. The lessee records a periodic depreciation charge to gradually reduce the carrying amount of the fixed asset in its accounting records. The lessor has revenue equal to the present value of the future cash flows from the lease, and records the expenses associated with the lease. For the lessor, a lease receivable is recorded on the lessor's balance sheet and recognizes the interest income as it is paid. If none of the above factors can be satisfied, the transaction is an operating lease. In that event, the lessee is able to deduct the lease payment as a business expense and the leased asset is not treated as an asset of the lessee.

Note: Until late 2019 all operating leases were effectively "tax leases." But, as of December 2019, an operating lease that lasts longer than one year requires the lessor to account for the leased asset(s) on its own balance sheet. Because of this, operating leases that last longer than a year are not tax leases. The reason for the rule change by the Financial Accounting Standards Board is that enough companies were gaming the system to keep assets off their books. Before the rule change, only capital leases had to be recognized on the lessee's balance sheet.

For tax purposes, a capital lease is treated more like a purchase financed by a loan. The farmer, as the deemed owner for tax purposes, can claim depreciation deductions on the leased equipment over its applicable recovery period (typically 5 or 7 years). In addition, a portion of each lease payment under a capital lease is treated as interest expense and is deductible as such. The remaining portion represents the principal payment. The lease agreement often specifies the interest rate and the allocation between principal and interest. Also, the lessee I.R.C. §179 (expense method depreciation) and/or bonus depreciation subject to the usual limitations and requirements. This can provide a significant tax advantage in the year the equipment is placed in service.

Note: The full lease payment is *not* deductible as an operating expense. Instead, the farmer deducts depreciation and the interest portion of the payment.

Compared to the immediate deduction of operating lease payments, the combination of depreciation and interest deductions under a capital lease may result in lower deductions in the initial years.

If the farmer exercises a purchase option at the end of a capital lease and subsequently sells the equipment, the tax implications would be similar to selling equipment that was originally purchased.

Operating lease. With an operating lease the asset owner (lessor) transfers only the right to use the property to the farmer. Ownership is not transferred as it is with a capital lease, and possession of the property reverts to the lessor at the end of the lease term. The farmer deducts the full lease payment and there is no impact on the farmer's balance sheet. Generally, the I.R.C. §179 expense method depreciation and bonus depreciation are not applicable to leased property under an operating lease because the farmer does not own the equipment.

Since the farmer does not own the equipment under an operating lease, the sale or trade-in of the leased asset is typically not a concern for the lessee. The equipment is simply returned to the leasing company at the end of the lease term.

Caution: Leases can be kept off a lessee's financial statements, which could provide a misleading picture of the lessee's finances.

Leasing and tax planning. The decision to lease or buy farm equipment should be made after careful consideration of various factors, including the farm's financial situation, cash flow needs, tax objectives, and operational requirements. If preserving cash flow is a priority, an operating lease with lower upfront costs and predictable payments might be more attractive. Also, the immediate deductibility of operating lease payments can be beneficial for reducing taxable income in the short term. However, the long-term tax advantages of ownership through depreciation and potential I.R.C. §179/bonus depreciation under a capital lease should also be considered.

Farmers with a high taxable income might prefer a capital lease with I.R.C. §179/bonus depreciation to offset that income quickly. Those with lower or fluctuating income might prefer the consistent deduction of an operating lease. If tax rates are expected to decrease, accelerating deductions into the current year (via capital lease/depreciation) can be advantageous. If rates are expected to increase, deferring deductions might be better. While less common now for many farmers, historically, large depreciation deductions could trigger AMT, which could reduce the benefit. The equipment must be primarily for business use to qualify for these deductions.

Conclusion

Regardless of whether equipment is leased under an operating or capital lease, meticulous record-keeping is essential for tax purposes. This includes maintaining copies of the lease agreement, payment schedules, and any related documentation. For capital leases, tracking depreciation and interest deductions is crucial.

Farm equipment leasing presents a compelling alternative to outright purchase, offering potential benefits such as lower upfront costs, access to newer technology, and predictable expenses. This is particularly the case for a farmer that frequently upgrades equipment or uses equipment for a relatively short period, leasing can mitigate the risks associated with ownership and depreciation.

Understanding the distinction between operating and capital leases and their respective income tax effects is paramount for farmers to make informed decisions that optimize their financial and operational strategies. By carefully evaluating their individual circumstances and seeking professional tax advice, farmers can leverage leasing to acquire the essential equipment they need while effectively managing their tax obligations.

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