Farm Depreciation

IOWA STATE UNIVERSITY
CALT
Center for Agricultural Law and Taxation

Depreciation

- Because farming is a capital intensive industry, a farmer is allowed cost recovery or depreciation on machinery, equipment, and buildings
- You can depreciate most types of tangible property (except land), such as buildings, machinery, equipment, vehicles, certain livestock, and furniture
- You can also depreciate certain intangible property, such as copyrights, patents, and computer software
- To be depreciable, the property must meet all the following requirements.
  - It must be property you own.
  - It must be used in your business or income producing activity
  - It must have a determinable useful life.
  - It must have a useful life that extends substantially beyond the year you place it in service.

Own the Property

- You are considered as owning property even if it is subject to a debt.
- **Leased property.** You can depreciate leased property only if you retain the incidents of ownership in the property
  - This means you bear the burden of exhaustion of the capital investment in the property
  - Therefore, if you lease property from someone to use in your trade or business or for the production of income, you generally cannot depreciate its cost because you do not retain the incidents of ownership
  - You can, however, depreciate any capital improvements you make to the leased property
    - I would go through the factors established by the Regulations and the Tax Court for determining the distinction between a lease and a sale with a retained security interest
- If you lease property to someone, you generally can depreciate its cost even if the lessee (the person leasing from you) has agreed to preserve, replace, renew, and maintain the property

Property Used in Your Business or Income-Producing Activity

- To claim depreciation on property, you must use it in your business or income producing activity
- If you use property to produce income the income must be taxable

Property Having a Determinable Useful Life

- To be depreciable, your property must have a determinable useful life
- This means it must be something that wears out, decays, gets used up, becomes obsolete, or loses its value from natural causes
- Depreciation "Life" is not based on how long the farmer will use the asset but rather "life" is based on an assignment of "life" based on tax law {Rev. Proc. 87-57]

Eight MACRS Classes

MACRS Class	Life
3 year Property	4 years or less
5 year property	More than four years but less than 10 years
7 year property	10 years or more but less than 16 years
10 year property	16 years or more but less than 25 years
15 year property	20 years or more but less than 25 years
20 year property	25 years or more other than §1250 property with an ADR life of 27 ½ years or more
27 ½ years property	Residential rental property
39 year property (31 ½ if acquired before 05/13/1993)	Non-residential real property

MACRS

- MACRS stands for modified accelerated cost recovery system
- It is the current system allowed in the United States to calculate tax deductions on account of depreciation for depreciable assets (other than intangible assets)
- IRS Form 4562 is used to claim depreciation deduction.
- It allows a larger deduction in early years and lower deductions in later years when compared to the straight-line method
  - There are two sub-system of MACRS:
  - the general depreciation system (GDS)
  - alternate depreciation system (ADS).

Depreciation

- The same depreciation rules apply to farming as to any other business except farm property is depreciated ay 150% of straight-line, non-farm property is 200%
- Under MACRS (GDS) General Depreciation System
  - The recovery periods are 3, 5, 7, 10, 15, and 20 years
  - Most real property is classified as either residential rental, or nonresidential (commercial) real property, with assigned recovery periods of 27.5 and 39 years respectively
  - For nonresidential real property acquired before May 13, 1993, the recovery period is 31.5 years
  - However, farm buildings, such as barns and machine sheds, are assigned a 20-year recovery period.

Depreciation Rules Unique to Farming

- Depreciation on farm property placed in service after 1988 is, generally, limited to 150% declining balance;
- Farm buildings (except single purpose agriculture or horticulture structures within the meaning of IRC section 168(1)(13) are assigned a 20-year recovery period); and
- Temp. Reg. 1.274-6T(b) allows a farmer to claim 75% business use of a vehicle without substantiation if the vehicle is used most of the normal business day directly in connection with the business of operating a farm. (i.e. cultivating land or raising or harvesting any agricultural or horticultural commodity, or the raising, shearing, feeding, caring for, training or managing animals, or incidental thereto, trips to feed and supply stores.)

ADS required for some farmers

- If you elect not to apply the uniform capitalization rules to any plant produced in your farming business, you must use ADS
- You must use ADS for all property you place in service in any year the election is in effect
- §263A

Electing a Different Method

- You can elect a different method for depreciation for certain types of property
- You must make the election by the due date of the return (including extensions) for the year you placed the property in service
- However, if you timely filed your return for the year without making the election, you still can make the election by filing an amended return within 6 months of the due date of the return (excluding extensions)
- Attach the election to the amended return and write "Filed pursuant to section 301.9100-2" on the election statement. File the amended return at the same address you filed the original return. Once you make the election, you cannot change it.

Electing a Different Method

- **Farm property**
  - Instead of using the 150% declining balance method over a GDS recovery period for property you use in a farming business (other than real property), you can elect to depreciate it using either of the following methods.
    - The straight line method over a GDS recovery period
    - The straight line method over an ADS recovery period.

Steps

- Figure out the class of the property
- Figure out the required depreciation convention
  - mid-month
  - mid-quarter
  - half-year
- Determine the depreciation method to be applied: depreciation is charged on the cost based on 3 different depreciation methods: 150% declining balance, 200% declining balance and straight-line method.

3 year Property

- Tangible business property with an ADR class life of 4 years or less is 3 year property
  - Tractor units for over-the-road use.
  - Any race horse over 2 years old when placed in service. (All race horses placed in service after December 31, 2008, and before January 1, 2015, are deemed to be 3-year property, regardless of age.)
  - Any other horse (other than a race horse) over 12 years old when placed in service.
  - Qualified rent-to-own property
  - Hogs held for breeding purposes.
  - Tangible business property is considered 3 year property if it is used in connection with research and experimentation

5 year Property

- All purchased dairy and breeding livestock (except hogs and horses included in the 3 or 7 year classes, respectively)
- Automobiles, light trucks (under 13,000 lbs unloaded) and heavy-duty trucks (not tractor trailer trucks)
- Computers and peripheral equipment, typewriters, copiers, and adding machines
- Logging machinery and equipment
- Breeding cattle and dairy cattle
- Appliances, carpets, furniture, etc., used in a residential rental real estate activity.
- Certain geothermal, solar, and wind energy property.

7 year Property

- All farm machinery and equipment (Except NEW farm machinery and equipment in 2009 ONLY – see 5 year property above)
- Silos, grain storage bins, fences, and paved barnyards
- Breeding horses or workhorses (12 years old or younger)
- Race horses under 2 years of age placed in service before January 1, 2009, or after December 31, 2013
- Anaerobic (methane) digesters
- Office furniture and fixtures (such as desks, files, and safes).
- Any property that does not have a class life and has not been designated by law as being in any other class.
- Certain motorsports entertainment complex property placed in service before January 1, 2015.
- Any natural gas gathering line placed in service after April 11, 2005
- Vineyard trellises are 7-year property – Trentadue v. Comr., 128 T.C. No. 8 (2007)

10 year Property

- Single-purpose livestock and horticultural structures (7 year property if placed in service before 1989)
- Orchards, groves and vineyards (15 year property if placed in service before 1989)
- Vessels, barges, tugs, and similar water transportation equipment
- Qualified small electric meter and qualified smart electric grid system placed in service on or after October 3, 2008.

15-Year Property

- Certain improvements made directly to land or added to it (such as shrubbery, landscaping, fences, roads, sidewalks, transmission towers, bridges, canals, waterways, wharves and dock bridges). Does not include land improvements that are explicitly included in any other class, or buildings or structural components
- Any retail motor fuels outlet such as a convenience store.
- Any municipal wastewater treatment plant.
- Any qualified leasehold improvement property placed in service before January 1, 2015.
- Any qualified restaurant property placed in service before January 1, 2015.
- Any qualified retail improvement property placed in service before January 1, 2015
- Initial clearing and grading land improvements for gas utility property.

15-Year Property

- Electric transmission property (that is section 1245 property) used in the transmission at 69 or more kilovolts of electricity placed in service after April 11, 2005.
- Any natural gas distribution line placed in service after April 11, 2005 and before January 1, 2011.
- Any qualified retail improvement property placed in service before January 1, 2015.
- Orchards, groves, and vineyards when they reach the production stage if they were placed in service before 1989
- Wells and irrigation equipment

MACRS Classes 20 Years and Higher*

- Twenty-year property includes farm buildings such as general-purpose barns, machine sheds, and many storage buildings like hoop buildings – other than single purpose agricultural or horticultural structures
- Municipal sewers not classified as 25-year property.
- Initial clearing and grading land improvements for electric utility transmission and distribution plants.
- Property that is 27 1/2 year includes residential rental property that is rented out. (Property that is used for employees and not rented to them is 20 year property.)
- Property that is 39 year (31 1⁄2 if acquired before May 13, 1993) includes nonresidential real property.

Placed in Service

- Property is placed in service when it is ready and available for a specific use, whether in a business activity, an income producing activity, a tax-exempt activity, or a personal activity. Even if you are not using the property, it is in service when it is ready and available for its specific use.

Example: Placed In Service

- You bought a planter for use in your farm business
- The planter was delivered in December 2013 after harvest was over
- You begin to depreciate the planter for 2013 because it was ready and available for its specific use in 2013, even though it will not be used until the spring of 2014.
- If your planter comes unassembled in December 2013 and is put together in February 2014, it is not placed in service until 2014. You begin to depreciate it in 2014.
- If your planter was delivered and assembled in February 2014 but not used until April 2014, it is placed in service in February 2014, because this is when the planter was ready for its specified use. You begin to depreciate it in 2014.

Retired From Service

- You stop depreciating property when you retire it from service, even if you have not fully recovered its cost or other basis
- You retire property from service when you permanently withdraw it from use in a trade or business or from use in the production of income because of any of the following events
- You claimed the incorrect amount because of a mathematical error made in any year. You claimed the incorrect amount because of a posting error made in any year, for ex ample, omitting an asset from the depreciation schedule.

Retired From Service

- You sell or exchange the property
- You convert the property to personal use
- You abandon the property.
- You have not adopted a method of accounting for the property placed in service by you in tax years ending after December 29, 2003
- You claimed the incorrect amount on property placed in service by you in tax years ending before December 30, 2003
- You transfer the property to a supplies or scrap account
- The property is destroyed

Farmers

- Assets used in farming are required to use the 150% declining balance method
- Must look at the business rather than the function of the asset
- Classification of the asset can be found by using Rev. Proc. 87-56 and 88-22

Livestock

- Livestock purchased for draft, breeding, or dairy purposes can be depreciated only if they are not kept in an inventory account
- Livestock you raise usually has no depreciable basis because the costs of raising them are deducted and not added to their basis.

Immature livestock "placed in service"

- Depreciation for livestock begins when the livestock reaches the age of maturity
- If you bought immature livestock for drafting purposes, depreciation begins when they can be worked
- If you bought immature livestock for dairy purposes, depreciation begins when they can be milked
- If you bought immature livestock for breeding purposes, depreciation begins when they can be bred
- Your basis for depreciation is your initial cost for the immature livestock.

Fruit or nut trees and vines.

- If you acquire an orchard, grove, or vineyard before the trees or vines have reached the income producing stage, and they have a pre-productive period of more than 2 years, you must capitalize the preproductive period costs under the uniform capitalization rules (unless you elect not to use these rules)
- Your depreciation begins when the trees and vines reach the income producing stage (that is, when they bear fruit, nuts, or grapes in quantities sufficient to commercially warrant harvesting).

Buildings and Structures

- Farm real property has 4 possible classifications
  - Land improvements = 15 years
  - Single purpose agriculture or horticulture structures = 10 years
  - Farm buildings = 20 years
  - §1245 property no class life = 7 years

Table 4-1. **Depreciation Methods**

Note. The declining balance method is abbreviated as DB and the straight line method is abbreviated as SL.

Method	Type of Property	Benefit
GDS using 200% DB	• Nonfarm 3-, 5-, 7-, and 10-year property	• Provides a greater deduction during the earlier recovery years • Changes to SL when that method provides an equal or greater deduction
GDS using 150% DB	• All farm property (except real property) • All 15- and 20-year property (except qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property placed in service before January 1, 2015) • Nonfarm 3-, 5-, 7-, and 10-year property	• Provides a greater deduction during the earlier recovery years • Changes to SL when that method provides an equal or greater deduction[1]
GDS using SL	• Nonresidential real property • Qualified leasehold improvement property placed in service before January 1, 2015 • Qualified restaurant property placed in service before January 1, 2015 • Qualified retail improvement property placed in service before January 1, 2015 • Residential rental property • Trees or vines bearing fruit or nuts • Water utility property • All 3-, 5-, 7-, 10-, 15-, and 20-year property[2] • Property for which you elected section 168(k)(4)	• Provides for equal yearly deductions (except for the first and last years)
ADS using SL	• Listed property used 50% or less for business • Property used predominantly outside the U.S. • Tax-exempt property • Tax-exempt bond-financed property • Farm property used when an election not to apply the uniform capitalization rules is in effect • Imported property[3] • Any property for which you elect to use this method[4]	• Provides for equal yearly deductions (except for the first and last years)

Single Purpose Structures

- Only greenhouses and livestock structures qualify
  - Used as housing, raising and feeding a certain type of livestock and their produce, and housing of equipment necessary
    - Hog houses
    - Poultry barns
    - Livestock sheds and
    - Milking parlors and similar shelters

§1245 Property

- Machinery or equipment which are an "integral" part of the manufacturing or production
- Structures that store potatoes, onions and other cold storage facilities for fruits and veggies
- Property that qualified for investment credit

Irrigation systems and water wells.

- Irrigation systems and wells used in a trade or business can be depreciated if their useful life can be determined
- You can depreciate irrigation systems and wells composed of masonry, concrete, tile, metal, or wood
- In addition, you can depreciate costs for moving dirt to construct irrigation systems and water wells composed of these materials
- However, land preparation costs for center pivot irrigation systems are not depreciable.
- **Dams, ponds, and terraces.** In general, you cannot depreciate earthen dams, ponds, and terraces unless the structures have a determinable useful life, but see Rudolph Invest. Co. case from early 1970s]

Computer software.

- Computer software is generally not a section 197 intangible even if acquired in connection with the acquisition of a business, if it meets all of the following tests.
  - It is readily available for purchase by the general public.
  - It is subject to a nonexclusive license.
  - It has not been substantially modified.
- If the software meets the tests above, it can be depreciated and may qualify for the section 179 expense deduction and the special depreciation allowance (if applicable)

Land Improvements Do Not Include

- Land improvements are not buildings

40% Rule

- Timing is important
- More than 40% of assets are placed in service after September 30
- Fall into mid-quarter convention rules
  - Does not apply to residential and non-residential real property
  - Mid month convention applies

Decedent

- Property owned by a decedent in the year od death
  - IRS limits the depreciation to the period before death

Anti-Churning Rules

- Six categories of rules
- Limit a taxpayer's ability to take advantage of the faster depreciation methods due to certain rules
  - Property that was acquired or leased from a related party
  - Property that was used during 1980 or 1986
  - Property that was used by a related party in 1980 or 1986
  - Property which is acquired in a transaction that is part of which the user of the property does not change
  - §1250 property is acquired in a tax-free exchange, involuntary conversion or property reacquisition
  - Other rules

Example

- Jack purchased $75,000 worth of equipment from his father who has owned the assets since 1979
- This property would be ineligible for ACRS or MACRS
- However, had Jack acquired the property from the estate of a related person, the property would be eligible for MACRS

What Cannot be Depreciated!

- Land
  - The cost of land generally includes the cost of clearing, grading, planting, and landscaping
- Property placed in service and disposed of in the same year
- You cannot depreciate a term interest in property created or acquired after July 27, 1989, for any period during which the remainder interest is held, directly or indirectly, by a person related to you
- Equipment used to build capital improvements
  - You must add otherwise allowable depreciation on the equipment during the period of construction to the basis of your improvements
- Intangible property such as section 197 intangibles. This property does not have a determinable useful life and generally cannot be depreciated
  - However, *Amortization is possible*

Inventory

- You can never depreciate inventory because it is not held for use in your business
- Inventory is any property you hold primarily for sale to customers in the ordinary course of your business.

Depreciation Recapture

- Recapture rules are different for real property and personal property

Recapture – Personal Property

- The gain represents the recovery of the depreciation deductions taken is treated as ordinary income and not capital gain
- However, any gain in excess of the amount related to a recovery of depreciation may still be treated as a capital gain.

Recapture- Personal Property

- The portion of the gain to be treated as ordinary income is the lesser of:
  - Gain realized or
  - The depreciation taken

Example

- On a sale or exchange, the difference between the adjusted basis of the property and either:
  - The amount realized or
  - The "recomputed basis", which ever is smaller, is treated as "ordinary income"
  - The recaptured basis is the adjusted basis of the property plus allowable depreciation deduction.

Steps

- Record the original purchase price of the asset. This price should include all costs paid to acquire the assets, such as taxes and commissions
- Compute the depreciation expense that you took or that was allowed
- Subtract the taken or allowable depreciation expense from your original cost basis
- Record the amount of your sales proceeds. This is your net amount

Steps

- Subtract your adjusted cost basis from your sales proceeds. This is the amount of gain you have realized
- Compare your realized gain with your depreciation expense
- The lower of these two figures is the amount the IRS considers to be depreciation recapture

Example
Amount of Adjusted Basis

- If you paid $25,000 for a tractor and took $4,000 in depreciation expenses, your new adjusted cost basis would be $25,000 minus $4,000, or $21,000.

Example
Sale Proceeds

- Sell the tractor for $29,000

Example
Gain Realized

- Sales Proceeds $29,000
- Adjusted Basis $21,000
- Gain Realized $ 8,000

Example
Recapture

- Compare the realized gain with the depreciation expense
- Realized Gain $ 8,000
- Depreciation Expense $ 4,000
- Ordinary Income = $4,000
- Capital Gain = $4,000

Example 2

- Building Original Price $500,000
- Depreciation Claimed $100,000
- Adjusted Basis $400,000
- Selling Price $550,000

Example 2
Realized Gain

- Sales Price $550,000
- Adjusted Basis $400,000
- Realized Gain $150,000
- Compare the realized gain with the depreciation expense
- Realized Gain $150,000
- Depreciation Expense $100,000
- Ordinary Income = $100,000
- Capital Gain = $50,000

Scoop Dates for Post Filing Season

- June 24, 2015
- July 1, 2015
- July 15, 2015
- August 5, 2015
- September 23, 2015
- October 21, 2015

June Webinars

- Confronting a Tax Lien
- Payment Options for Your Clients
- Business Use of Home
- http://www.calt.iastate.edu/seminar/2015-06-02/june-2015-webinars

July Webinars

- **The Affordable Care Act – July 1, Noon to 2:00 (2 hours of CPE) -** A review of the ACA provisions and changes that have occurred with the law since enactment will be discussed. We will review the basics aspects you faced during the 2015 filing season and provide additional clarification on issues that were problematic. In addition, we will review some of the more difficult reconciliation issues as it relates to the Premium Tax Credit.
- **Foreign Account Tax Compliance Act (FATCA) – July 2, Noon to 1:00 -** The Foreign Account Tax Compliance Act (FATCA) is a United States federal law that requires United States persons, including individuals who live outside the United States, to report their financial accounts held outside of the United States, and requires foreign financial institutions to report to the Internal Revenue Service (IRS) about their U.S. clients. We will provide an overview of the law and filing requirements.
- **Preparing for a Gambling Audit – July 6, Noon to 1:00 -** Your client gambles, whether it slots or poker we will review the recent IRS issues as they relate to auditing your client who has gaming income. What advice should you give a client with this type of income and what records will IRS accept during the audit process will be discussed.
- **Basis of a Partnership – July 7, Noon to 1:00 -** Discussion will include filing requirements, hiring employees, how to make estimated tax payments and how the income will show up on the personal return. A general overview of the partnership and some of the problematic issues related to filing for this business entity.
- **The Partnership Form K-1 – July 8, Noon to 1:00 -** An overview of Form 1065 K-1 preparation and the resulting Form 1040 income issues will be discussed.
- **Bartering and Trading Income – July 13, Noon to 1:00 -** A question IRS auditor always ask, Dow you have any bartering or trading income? How this income is reported and the adjustments needed to be made on the tax return will be discussed.

July Webinars

- **Correspondence Audits – July 14, Noon – 1:00 -** IRS's chief audit stream is correspondence audit. They do more of them than face to face and other types of audits combined. Responding to the audit request and providing logical and concise information to resolve the issue is an important part of the audit process. What are the do's and don'ts in providing the information and how best to handle the audit will be discussed.
- **FinCEN – July 10, Noon to 1:00 -** FinCEN's mission is to safeguard the financial system from illicit use and combat money laundering and promote national security through the collection, analysis, and dissemination of financial intelligence and strategic use of financial authorities. We will review the application process to file a FinCen Form 114 and the BSA E-Filing overview. If your client has a financial interest in or signature authority over a foreign financial account, including a bank account, brokerage account, mutual fund, trust, or other type of foreign financial account, exceeding certain thresholds, the Bank Secrecy Act may require them to report the account yearly to the Department of Treasury by electronically filing a Financial Crimes Enforcement Network (FinCEN) 114, *Report of Foreign Bank and Financial Accounts* (FBAR).
- **Report of Foreign Bank and Financial Accounts (FBAR) – July 21, Noon to 1:00 -** United States persons are required to file an FBAR if: (1)The United States person had a financial interest in or signature authority over at least one financial account located outside of the United States; and (2) The aggregate value of all foreign financial accounts exceeded $10,000 at any time during the calendar year reported. This session will review the FBAR filing requirements and provide you with information when both the FBAR and the Form 114 both need to be filed, as well as an explanation of the differences between to the two requirements.
- **Preparing for an IRS Audit – July 22, Noon to 1:00 -** Your client has been informed that they will be subject to and IRS audit. Tips on how to preparer, what information you should gather, pre-audit analysis and other issues will be discussed.
- **Issues Related to Estates, Procedures and Developments in Estate Tax Law – July 23, Noon to 1:00 -** What's new with Estates tax law? An overview of some of the recent estate issues and a review of typical estate tax issues that you face with your clients.

CALT Website

http://www.calt.iastate.edu/

Tour of the CALT Website

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