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Machinery and Equipment Lease or Purchase Considerations [*]

***Mark Dikeman**, Executive Director*
Kansas Farm Management Association
Department of Agricultural Economics, Kansas State University

Introduction

Agriculture is a capital-intensive business, requiring significant investment in land, machinery, equipment, and breeding livestock. When making capital purchase decisions, agricultural business managers must determine the most appropriate method of acquiring the property or acquiring the use of the property. Producers should evaluate the long-term economic impact of a decision like this by looking at a number of factors, including their financial position, income tax brackets, interest rates, lease terms, and expected use of the property. Options for acquisition include:

1. **Outright purchase** – business cash is used to make the purchase
2. **Financed purchase** – purchase made in conjunction with a lender, allowing a producer to pay for the purchase over time
3. **Operating lease** – a payment for short-term use of property, usually with payment based on some measurable unit (engine or separator hours, miles, bales, acres, etc.)
4. **Capital lease** (conditional sales contract) – a longer-term lease (usually several years) that frequently includes an option to purchase the leased property at the end of the lease for a nominal amount

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There are advantages and disadvantages to either a lease or purchase that producers need to consider when acquiring machinery or equipment.

Purchase

An outright or cash purchase may make economic sense if the property will be used in the business beyond a few years. In some cases, an outright purchase may give the buyer more negotiating power with the seller than a financed purchase or lease. A significant disadvantage to an outright purchase is that it requires the use of business capital (cash) to complete the transaction. For some operations, cash may not be available to make the purchase, and for others that capital might be better utilized to purchase other farm or ranch inputs.

A financed purchase may require business capital in the form of a down payment. This down payment may be equity in traded-in equipment or cash. In either case, business capital is needed, although not to the extent of an outright purchase. In a financed purchase, a security agreement is often required, specifying terms of the loan, including interest rate and payment amount. The interest component of a payment compensates the lender for use of their capital.

For both purchase options, a producer can deduct the cost of the machinery or equipment though an allowance for depreciation. Current depreciation rules allow significant flexibility in the timing of the deduction for depreciation, especially when compared to an operating lease. If either §179 deduction or special depreciation allowance (bonus depreciation) are utilized, the entire cost of the purchase may be deducted in the year the property is placed in service. Several other elections are available in the first year that may change the timing of the depreciation deduction. When making depreciation elections, consideration should be given to the timing of depreciation deductions compared to required payments. See *"Depreciation: An Introduction"* on ruraltax.org for more information on depreciation options available to agricultural operations.

In either the case of an outright purchase or financed purchase, the buyer will be responsible for maintaining, repairing, and insuring the machinery or equipment.

Lease

A lease is typically defined as payment for the use of property over a period of time without ownership of that property. A lease of machinery or equipment is often considered to be easier to obtain than a financing agreement, and a producer may be able to negotiate lease terms that better fit their needs or cash flow situation. In addition, there may be lower capital requirements for a lease compared to a purchase. A lease, especially an operating lease, may better meet the needs of a business if the property associated with the lease is used infrequently or is only needed for a short period of time.

Compared to a loan payment that contains a portion that is principal, which is not deductible, a lease payment is generally a fully deductible business expense. Depending on the terms of the lease, an operator may or may not be responsible for maintaining, repairing, and insuring the property, so review lease documents and requirements carefully.

A lease may be either an operating lease or a capital (financial) lease. An operating lease is often for a shorter time period and usually involves a variable that measures some unit of use. Operating leases of machinery or equipment may be based on engine or separator hours, miles, bales, acres, etc. For example, an operating lease for a combine may be a payment rate for each separator hour that it was used. In an operating lease such as this, the cost for the lease may not be known up front. In contrast, a capital lease will often be a fixed payment over a longer period of time. Typically, the payment rate will not change, regardless of how much the property is used.

It is important to identify a lease as either operating or capital. If the lease is determined to be a capital lease, it is treated as a conditional sales contract or a financed purchase. In this case, the property associated with the lease is depreciated and lease payments are considered to have both a principal and interest component. As mentioned above, the principal portion of the payment is not deducted as a business expense. In *IRS Publication 225, Farmer's Tax Guide*, the Internal Revenue Service outlines several factors that help to determine if a lease is an operating lease or capital lease. Ultimately, this determination is based on the intent of the parties involved, but the following factors may be used as a guide to understand intent. No single factor alone will determine intent.

In general, a lease will be considered a capital lease or conditional sales contract if one of the following factors applies:

1. The agreement applies part of each payment toward an equity interest you will receive
2. You get title to the property after you make a stated amount of required payments
3. The amount you must pay to use the property for a short time is a large part of the amount you would pay to get title to the property
4. You pay much more than the current fair rental value of the property
5. You have an option to buy the property at a nominal price compared to the value of the property when you may exercise the option. This value is determined when you make the agreement
6. You have an option to buy the property at a nominal price compared to the total amount you have to pay under the agreement
7. The agreement designates part of the payments as interest, or part of the payments can be easily recognized as interest

If a lease should be considered a conditional sales contract, it may be beneficial to compare it to financing options. By starting with the cost of the machinery or equipment, an effective interest rate can be calculated from the payment amount and compared to interest rates offered by other lenders.

Producers should be aware of a potential hidden tax trap when entering into a lease that is not considered a capital lease. This may occur when machinery or equipment that the producer previously owned is given to the dealer as equity in the lease or as a down payment. In this type of transaction, the property given up by the producer must be treated as sold, resulting in depreciation recapture that must be recognized as taxable gain on their income tax return.

Conclusion

When acquiring machinery or equipment, agricultural producers should evaluate several factors to determine if a lease or purchase is more appropriate. Lease versus purchase decision tools are available online through several University Extension sites that can help calculate the economic impact on an agricultural operation. Producers may consider consulting with a trusted advisor to evaluate the decision who does not have a financial interest in the decision.

IRS Publications

IRS forms and publications can be found by going to www.irs.gov and typing in the name of the publication/form or the publication/form number in the search bar toward the top of the webpage. Publications may be viewed online or downloaded.

Additional Topics

This fact sheet was written as part of Rural Tax Education, a national effort including Cooperative Extension programs at participating land-grant universities to provide income tax education materials to farmers, ranchers, and other agricultural producers. For a list of universities involved, other fact sheets, and additional information related to agricultural income tax, please see RuralTax.org.