

# Tax Guidelines

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Provided for your information and convenience. We do encourage, however, for you and your customers to consult directly with your/their personal Tax Preparer or Accountant before making tax decisions.

## Definitions

- **True lease or a tax-oriented lease** - A lease, which for IRS purposes, the lessor qualifies for the tax benefits of ownership and the lessee can claim the entire lease payment as a tax deduction.
- **Non-tax lease, conditional sale or installment sale lease** - A lease, which for IRS purposes is a loan. In practice, the lessor treats the transaction as a loan while leaving it up to the lessee to make their own tax treatment determination. Many lessees fully deduct on their tax return the lease payments from a non-tax lease. Their risk comes from an IRS audit. AgStar does offer both tax and non-tax leases.
- **“Operating Lease” Vs. a “Capital Lease” or often referred to as a “Finance Lease”** - These are accounting terms and are applicable to customers who have financial statements prepared in accordance with GAAP. There are specific criteria under GAAP that when applied to the characteristics of a specific lease determine the accounting treatment for that lease. An ‘Operating Lease’ is accounted for as an off balance sheet item, while a ‘Capital Lease’, also called a ‘Finance Lease’, is accounted for as an on balance sheet item, very similar to accounting for a loan. Your leasing specialist can help you determine the appropriate accounting treatment.
- **Placed in service (PIS)** - This is an IRS defined term. Depreciation cannot be taken or lease payments deducted as an expense, prior to the item being PIS. To be PIS, the item must have been delivered to its’ intended location, fully assembled and available for its’ intended use.
- **Depreciable Life** – The period of time over which an asset can be depreciated per IRS schedule. See ‘MACRS’. The IRS allows several different methods of depreciation, including ‘Straight Line’.
- **MACRS (Modified Accelerated Cost Recovery System)** - The method of depreciation that most taxpayers use on items that they own. MACRS depreciation allows for greater deductions in the initial years of owning the asset, relative to straight-line depreciation method.



- **Straight Line Depreciation** – A less aggressive form of depreciation (as opposed to MACRS) where the asset cost is equally divided by the number of years of depreciation, with adjustments made for the first and last year. For example, equipment that would qualify for 7 year MACRS depreciation would be depreciated at the rate of 10% per year (for years 2 – 10), using a mid-year convention the first and 11<sup>th</sup> year being 5% each. Many coops for example use straight-line depreciation for both their tax records and financial accounting records to avoid any book to tax records differences.
- **Mid-year or mid-quarter convention** - The IRS does not allow a full years' depreciation in the first year the item was PIS. The actual depreciation schedule for an item is set by IRS published tables.
- **IRC** - Internal Revenue Code.
- **Section 179** - A section in the IRC designed as a tax break for small businesses. A designated dollar amount (\$100,000 in 2003) of capital assets PIS in any one year can be expensed in the current year rather than depreciated over time. In addition, there is a dollar for dollar phase out of the 179 deduction for every dollar of capital acquired through ownership above \$400,000.
- **Purchase order/invoice/bill of sale & sales/use tax** - In tax leases, the purchase order (also referred to as the invoice or bill of sale) is made out showing your AgStar as the buyer, including a complete description of the item(s) being leased including serial number(s), the sales price, no trade-ins and no sales tax. You will then give the dealer a **Resale Exemption Certificate** for their records. You will pay the dealer directly, based off the purchase order and all appropriate documents being signed. Sales/use tax is assessed and remitted with each lease payment (in some States - sales/use tax must be paid up front, in this case there is no tax on the lease payment) based on the then applicable rate for the item being leased, multiplied by the lease payment amount. New farm machinery in MN and WI currently has a 0% sales/use tax levy, **while all licensed units (new or used trucks & trailers) are at the full sales tax rate.** Leases of facilities have special rules as it relates to sales/use tax. **Each State has its own particular laws and regulations regarding sales/use tax.** In non-tax leases, it is not critical how the invoice is made out, except for licensed units, where in a non-tax lease the invoice should be made out to the Lessee.
- **Use tax** - A State tax for using equipment on lease that is assessed against each lease payment. It is the same % as sales tax and is in lieu of sales tax. For \$1 residual, non-tax leases, sales/use tax is handled just like a loan. Use tax can be assessed at various levels within State Government (State, County or Municipality).



## **Farmer's Tax Guide – IRS Publication #225**

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### **Lease or Purchase**

If you lease equipment rather than buy it, determine whether the agreement is a lease or, in reality, a conditional sale contract. If the agreement is a lease, you can deduct rental payments for the use of the equipment in your trade or business. If the agreement is a conditional sales contract and you have acquired, or will acquire, title to or equity in the equipment, the payments under the agreement, so far as they do not represent interest or other charges, are payments for the purchase of the equipment. You cannot deduct these payments as rent, but must capitalize the cost of the equipment and recover this cost through depreciation.

### **Intent**

Whether the agreement, which in form is a lease, is in substance a conditional sales contract depends on the intent of the parties. This intent is shown by the agreement, read in the light of the facts and circumstances existing at the time you made the agreement. In determining the intent, no single test, or special combination of tests, is absolutely definitive. However, in the absence of compelling and persuasive factors to the contrary, treat an agreement as a conditional sales contract, rather than a lease, if any of the following is true:

- 1) The agreement applies part of each payment toward an equity interest you will receive.
- 2) You receive title to the property after you pay a stated amount of required payments.
- 3) You must pay, over a short period of time, an amount that represents a large part of the price you would pay to buy 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 small price compared to the value of the property at the time you can exercise the option. Determine this value at the time of entering into the original agreement.
- 6) You have the option to buy the property at a small price compared to the total amount you must pay under the lease.
- 7) The lease designates some part of the payments as interest, or part of the payments is easy to recognize as interest.

**Motor vehicle leases.** Special rules apply to lease agreements that have a terminal rental adjustment clause. The clause will generally provide for a rental adjustment on termination of the lease. If your rental agreement contains a terminal rental adjustment clause, treat the agreement as a lease. See section 7701(h) of the Internal Revenue Code.



### **Sales/Use Tax:**

- In most states, sales/use tax is not collected up front. Rather, the purchase order is made out to the lessor - net of tax and the lessor collects the appropriate tax from the lessee on a per payment basis and remits to the state of residence.
- Non-tax or “Buck-Out” leases are handled much like a loan. As such, sales/use tax is collected up front and can be included in the lease. AgStar will not charge the client a monthly fee for the collection of sales/use tax.
- AgStar will collect tax both at a state and a county or municipal level, if appropriate.
- Depending on the state of residence of your lessee, the sales/use tax implications may be different. We will notify you if there is to be a different approach for the collection of sales/use tax based on your state of operation and the state of residence for your lessee.

### **Property and Personal Property Tax:**

- AgStar will not get involved in the payment of property or personal property tax relative to a lease. These two types of tax are the responsibility of the Lessee on an annual basis (or whatever periodic basis required).

### **Federal Excise Tax:**

- Federal excise tax (a 12% tax due on larger **new** trucks and trailers) can be paid up front by lessee, or upon credit approval, included in the lease amount.

### **Heavy Use Tax:**

- Heavy use tax is charged on power units only. The tax is charged on units that have a gross weight of 55,000 pounds or more. On new units the client must file a Heavy Vehicle Use Tax Return form # 2290 within the first month the unit is placed in service. On used unit registration, whomever is registering the unit must have a 2290 form stamp paid. Either the dealer or the individual that is selling the unit must provide this form.
- F.E.T. is charged on only new units. It is a 12% tax. Power units with a G.V.W.R. on the M.S.O. of 33,000 pounds or more will be charged F.E.T. Trailers with a G.V.W.R. of 26,000 or more on the M.S.O. will be charged on the F.ET.
- On pickups that have a G.V.W. loaded of over 6000 pounds on the MSO or stamped on the inside of the pickup door, then the full lease payment can be deducted if they claim the unit for 100% farm use. If the customer uses the IRS safe harbor rule of 75/25 then they would only deduct 75% of the lease payment. They can also apply up to \$75,000 towards their Section 179 if they were to purchase this unit and it met the 6,000-pound rule.

