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## **Agricultural Financing Issues – Distinguishing Between a Capital Lease and an Operating Lease**

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Economic conditions in much of agriculture have deteriorated over the past two years. Prices for many crops have dropped, livestock prices have come down from recent highs, and cash rents and land values have leveled off or fallen. In some instances, agricultural producers leveraged to expand their operations during the good times, only to find that the tougher farm economy has made things financially difficult.

In the downturn, legal and tax issues become critically important for many farmers and ranchers. Two of those, the capital lease/operating lease distinction and the rules surrounding the “buyer in the ordinary course,” are vital to understand so that unexpected negative consequences can be avoided.

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. Conversely, with an operating lease the asset owner (lessor) transfers only the right to use the property to the lessee. 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. As a result, if the transaction is a capital lease, 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. For tax purposes, the lessee deducts the interest portion of the capital lease payment as an expense, rather than the amount of the entire lease payment (which can be done with an operating lease).

So, what distinguishes a capital lease from an operating lease and why is the distinction important? There are at least a couple of reasons for properly characterizing capital and operating leases. One reason involves the fact that leases can be kept off a lessee’s financial statements, which could provide a misleading picture of the lessee’s finances. Another reason involves the proper tax characterization of the transaction. With an operating lease, the lessee deducts the lease payment as an operating expense and there is no impact on the lessee’s balance sheet. With a capital lease, however, the lessee recognizes the lease as an asset and the lease payment as a liability on the

balance sheet. Also, with a capital lease, the lessee claims an annual amount of depreciation and deducts the interest expense associated with the lease. Based on these distinctions, many businesses prefer to treat lease transactions as operating leases, sometimes when the structure of the transaction indicates that they should not.

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

- Ownership of the asset shifted from the lessee 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; 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.

**Note.** 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.

In the typical example, a farmer "trades in" equipment in return for not having to pay any of the operating lease payments or make a large down payment on the lease. If the trade is for a capital lease, with the IRS treating the transaction as a financing arrangement (*i.e.*, a loan), then no gain is triggered on the trade if no cash is received. But there also is no deduction for the lease payments (although interest may be deductible). If the trade constitutes an operating lease, the farmer has gain equal to the amount of "trade-in" value that is credited to the operating lease minus the farmer's tax cost in the equipment. The gain can be offset (partially or fully) with the lease expense (lease cost amortized for the year of sale).

Consider the following example:<sup>1</sup>

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<sup>1</sup> This example is provided by Paul Neiffer, CliftonLarsonAllen LLP, [www.farmcpatoday.com](http://www.farmcpatoday.com) blog.

On June 1, 2016, a farmer trades in a used, fully depreciated, tractor worth \$120,000 for a new tractor under an operating lease over four years. The farmer will have ordinary income of \$120,000 in 2016 and can deduct the lease payments made in 2016 and later years as a business expense. Had the trade occurred late in 2016, it is possible that no lease expense could be claimed in 2016, but that \$30,000 could be claimed as a lease expense deduction in each year of 2017-2020.

## **Conclusion**

Understanding the difference between a capital lease and an operating lease, is helpful to avoiding bad tax and legal results in agricultural transactions. That can be a big deal particularly when the agricultural economy turns south.