
Tax Considerations of Farm Transfers

(Revised 9 January 2013)

Introduction

There are alternative methods of transferring farm assets from one generation to the next. The most common methods are by sale, by gift, by transfer at death, by trade, or by transferring to a business entity. The income, gift and estate taxes differ among the alternatives. This section discusses the tax impact of the alternative methods. However, taxes are only one of several factors that should be considered when choosing a method for transferring the farm. Good business management, equity among heirs, security for the exiting generation and other personal and family goals should be considered as well.

Several different taxes are imposed on owners and operators of farm businesses such as local property taxes, state sales taxes, state and federal employment taxes, self-employment taxes, state and federal income taxes, federal gift taxes and state and federal death taxes. The method of transferring the farm business has a bigger impact on the income, self-employment, gift and death taxes than on the other taxes. Consequently, this section discusses the effect of each method of transferring the farm on those taxes.

The tax rules are illustrated by using Bella Acres as an example. A snapshot of the FMV and basis and assets owned by members of the Bella Acres family is in the appendix to this section.

Sale

If the farm is transferred by sale at the fair market value of the assets, there are no gift or death tax consequences. However, the seller must report the sale for state and federal income tax purposes. The income from the sale of some of the assets is also subject to self-employment tax.

Measuring gain or loss. Sale of farm assets is an event that requires the seller to recognize gain or loss realized from the sale of the assets. Gain or loss is the difference between the amount realized from the sale and the seller's income tax basis in the asset. The seller's **income tax basis** is generally the amount the seller paid for the asset, reduced by any part of that cost the seller has deducted as a business expense.

Example 1. If Grandpa sold his 59 acres of farmland to Dale for \$295,000, Grandpa must report \$283,200 of gain on his federal and state income tax returns. That gain is calculated by subtracting the \$11,800 basis from the \$295,000 sale price. All of that gain qualifies for the favorable long-term capital gains treatment discussed later. Grandpa has not made a gift, so there are no gift or death tax consequences from the sale.

<p>Note. The \$11,800 basis in the land is the original purchase price of the land. There is no reduction for depreciation because land cannot be depreciated for income tax purposes.</p>

Example 2. If Grandpa sold his cows to Bill and Carl for their \$130,000 fair market value, he must report the full \$130,000 sale price on his federal and state income tax returns. That

is the difference between the \$130,000 sale price and Grandpa's zero basis in the herd. His basis is zero because he raised all of the animals in the herd and deducted the cost of raising them in the year he incurred the expenses. As in Example 1, there are no gift or death tax consequences from the sale.

Example 3. If Dale sold one-half of his machinery to Bill and Carl for its \$58,934 fair market value, he must report the \$50,500 of gain as calculated below on his federal and state income tax returns.

Sale price (50% of \$117,868)	\$58,934
Basis (50% of \$16,868)	- 8,434
Gain	\$50,500

As discussed later, the \$50,500 gain is not treated as long-term capital gain and is not subject to self-employment tax. As in Example 1, there are no gift or death tax consequences from the sale.

Note. The \$50,500 of gain is reported on the income tax return by reporting the sale price of one-half of each piece of machinery, the basis of one-half of each piece of machinery and the resulting gain or loss for one-half of each piece of machinery. The gains and losses for all of the pieces are then combined and the net \$50,500 of gain is included in income.

The basis of each piece of machinery is calculated by subtracting the depreciation claimed for that piece of machinery from the original purchase price.

Character of gain or loss. Some of the gain or loss that is recognized on the sale of farm assets is taxed as **ordinary income**, which means it is taxed at the marginal income tax rate of the seller. The federal income rates for individuals currently range from 10% to 39.6%. The Wisconsin income tax rates for individuals currently range from 4.6% to 7.75%.

Some of the gain or loss is taxed as **long-term capital gains**, which means that it receives favorable income-tax treatment. For federal income taxes, long-term capital gains are taxed at the lesser of the seller's marginal income tax rate or at the applicable capital gains rate, which currently ranges from 0% to 28%. The current Wisconsin income tax rules allow 60% of long-term capital gains from farm assets to be excluded from income and the remaining 40% is taxed at the seller's marginal income tax rate.

Some of the gain or loss that is taxed as ordinary income is also subject to the **self-employment tax**. The self-employment tax is the sum of the social security tax and the Medicare tax. The social security tax is 12.4% of the first \$113,700 (for 2013) of self-employment income. (The \$113,700 wage base is indexed for inflation) The Medicare tax is 2.9% of self-employment income plus an additional 0.9% of the self-employment income that exceeds \$200,000 (\$250,000 for married filing jointly; \$125,000 for married filing separately). However, the \$200,000 (\$250,000; \$125,000) threshold is reduced by wages.

Example 4. Assume that Gwen received \$100,000 of wages from an off-farm job in 2013 and Dale had \$175,000 of self-employment income from the farm. Gwen's wages have no effect on Dale's social security tax, which is \$14,099 (\$113,700 × 12.4%). However, Gwen's wages reduce the base for calculating the additional Medicare tax on Dale's self-employment income from \$250,000 to \$150,000 if they file jointly.

Therefore, Dale's Medicare tax is calculated as follows:

SE income	\$175,000	
Basic Medicare rate	× 2.9%	\$ 5,075
SE income	\$175,000	
Threshold	– 150,000	
Base	\$ 25,000	
Addnl Medicare rate	0.9%	225
Total Medicare tax		\$5,300

Dale's total self-employment tax is \$19,399—the sum of his \$14,099 social security tax and his \$5,300 Medicare tax.

Note. If Gwen and Dale filed separately, Dale's threshold for the additional Medicare tax would be \$125,000. And his additional Medicare tax would increase by \$225 to \$450 ($\$50,000 \times 0.9\%$).

Three categories of gain. The above tax treatment of ordinary income, long-term capital gains, and self-employment income causes gain or loss to fall into one of three categories for purposes of income and self-employment taxes.

1. Gain or loss from the sale of farm assets that were held for sale in the ordinary course of the farming business is taxed at the seller's marginal income tax rate and is also subject to self-employment taxes. Assets that fall into this category include grain and other produce as well as livestock that was raised to be sold on the slaughter market rather than to be used for breeding or dairy purposes.

Note. If one spouse is treated as the sole proprietor of the farming business, all of the farm income is treated as his or hers for purposes of the self-employment tax even though Wisconsin's marital property rules cause the income to be divided equally between the spouses for purposes of both federal and Wisconsin income taxes.

Example 5. The bull calves that Grandpa and Dale sell are included in this first category. The gain on sale of those calves is subject to both ordinary income tax and self-employment tax. The gain is the full sale price because the costs of raising the calves have been deducted resulting in a zero basis.

2. Some of the gain or loss from the sale of assets that were used in the trade or business to produce income is taxed at the seller's marginal income tax rate but is not subject to self-employment tax. Two different rules require gains or losses to fall into this category.

- a. Gain from assets (other than buildings) that were depreciated is in this category to the extent that depreciation was claimed on the asset. In most cases, that is all of the gain because the asset is sold for less than its purchase price.

Example 6. If Bill and Carl bought half of Dale's machinery for its fair market value, Dale would have to report \$50,500 of gain as calculated in Example 3. Because Dale claimed more than \$50,500 of depreciation on that one-half of his machinery, he must report all of the gain as ordinary income but the gain is not subject to self-employment tax. If Dale sold the machinery for more than he paid for it, \$50,500 of the gain falls in this category and the remaining gain falls in the third category, discussed later.

- b. Gain from young livestock that was intended to go into the breeding or dairy herd but does not meet the required holding period is in this category. The required holding period is 12 months or more for all livestock except cattle and horses. Cattle and horses must be held 24 months or more.

Example 7. If Dale sold some heifers to Bill and Carl that he was raising for the dairy herd, the gain from the sale falls in this category if they were held less than 24 months before the sale. The holding period for raised heifers begins on the date of birth. For purchased heifers, the holding period begins on the date of purchase.

3. Some of the gain or loss from the sale of assets that were used in the trade or business to produce income is taxed under the following rules.
 - a. If there is a net gain from the sale of these assets, the net gain is treated as a long-term capital gain.
 - b. If there is a net loss, the net loss is treated as a deduction against ordinary income.

Example 8. If Grandpa sold the 10 acre farmstead (including the house, barn and machine shed) to Dale for its fair market value, he would have the following gains and losses to report:

Sale price of house	\$ 150,000	
Basis of house	<u>- 30,000</u>	
Gain on house		\$120,000
Sale price of shed	5,000	
Basis of shed	<u>- 7,000</u>	
Loss on shed		- 2,000
Sale price of barn	0	
Basis of barn	<u>- 5,000</u>	
Loss on barn		- 5,000
Sale price of land	50,000	
Basis of land	<u>2,000</u>	
Gain on land		<u>48,000</u>
Net gain		\$161,000

The \$161,000 net gain is treated as long-term capital gain on Grandpa's income tax return.

If Grandpa had a \$150,000 basis in the house (instead of \$30,000) and a \$45,000 basis in the 10 acres (instead of \$2,000), he would realize a \$2,000 net loss as follows:

Sale price of house	\$ 150,000	
Basis of house	<u>- 150,000</u>	
Gain on house		\$ 0
Sale price of shed	5,000	
Basis of shed	<u>- 7,000</u>	
Loss on shed		- 2,000
Sale price of barn	0	
Basis of barn	<u>- 5,000</u>	
Loss on barn		- 5,000
Sale price of land	50,000	
Basis of land	<u>45,000</u>	
Gain on land		<u>5,000</u>
Net loss		\$ - 2,000

Grandpa reports the \$2,000 net loss as negative income on Part II of his Form 4797 and it reduces his taxable income but not his self-employment income.

Net Investment Income Tax. Beginning in 2013 there is a 3.8% tax on net investment income. However, the tax applies to the lesser of net investment income or the taxpayer's adjusted gross income in excess of \$200,000 (\$250,000 for married filing jointly; \$125,000 for married filing separately). Gain from selling farm assets is not included in net investment income but that gain could cause a farmer's adjusted gross income to exceed the \$200,000 (\$250,000; \$125,000) threshold and therefore make his or her net investment income from other sources subject to the 3.8% net investment income tax.

Example 9. Assume Grandpa had \$50,000 of adjusted gross income in 2013 before he included the \$161,000 gain from selling the 10 acre farmstead as shown in Example 8.

Also assume that \$5,000 of that \$50,000 is net investment income from his investment portfolio. None of the \$161,000 of gain is subject to the 3.8% net investment income tax, but that gain increases his adjusted gross income to \$211,000 (\$50,000 + \$161,000). Therefore, he owes the 3.8% tax on his \$5,000 of net investment income because it is less than the \$11,000 excess of his \$211,000 adjusted gross income over his \$200,000 threshold. His net investment income tax is \$190 ($\$5,000 \times 3.8\%$).

Installment Sale. Farm owners can sell assets under a contract that calls for part of the sale price to be paid in each of two or more years. Unless the sellers elect to report all of the gain in the year of the sale, they must report the gain as the principal payments are received.

Example 10. Assume Grandpa sold the 59 acres of farmland to Dale for \$295,000 on an installment contract. The contract requires Dale to pay \$29,500 down and \$29,500 each year for the next 9 years. It also requires Dale to pay 6% interest per year on the unpaid balance. Because Grandpa's basis in the farmland is \$11,800, he realizes \$283,200 of gain from the sale but the recognition of the gain is spread over the 10 years of the contract. Consequently, he reports \$28,320 of gain each year he receives \$29,500 of principal. If Grandpa has no other taxable income, all of the \$28,320 gain falls within his 10% and 15% income tax brackets and therefore qualifies for the 0% capital gains rate. Grandpa also reports the interest as ordinary income for the year it is received.

Observation. If Grandpa sold the 59 acres outright, he would have to report all of the \$283,200 of gain in the year of the sale. Most of that gain would exceed the 15% income tax bracket and would therefore be taxed at the 15% capital gains rate. Consequently, the installment sale reduces the tax rate on most of the gain from 15% to 0%.

Transfer by Gift

If farm assets are transferred by gift, there may be gift tax consequences. The transfer will also have an effect on the donee's income taxes because he or she will have a carryover basis in the property as discussed later.

Federal Gift Tax. The federal government imposes a gift tax on transfers of asset by gift, but an annual exclusion and a lifetime exclusion allow taxpayers to make substantial gifts without paying any gift taxes.

The **annual exclusion** is \$14,000 (in 2013) and is indexed for inflation. (It was \$13,000 for 2009—2012.) This exclusion allows each taxpayer to give up to \$14,000 each year to as many individuals as he or she chooses without any federal gift tax consequences. Although most gifts are made to family members such as children or grandchildren, the donees do not need to be related to the donor to qualify for the annual exclusion.

Example 11. Grandpa could give \$14,000 worth of cows to each Bill and Carl each year without triggering any gift tax consequences.

If the donor's gifts to a donee are \$14,000 or less each year, the donor does not have to report the gifts to that donee on a gift tax return for the year. Because birthday and other gifts are included in this total, it is a good idea to give a little less than \$14,000 of farm assets so that the other gifts during the year don't push the total over \$14,000.

Example 12. If Grandpa gave \$14,000 of cows to each Bill and Carl and gave them each a \$50 birthday gift, he is required to report the gifts on a gift tax return. The first \$14,000 of the gifts to each of them is not taxable. The remaining \$50 is a taxable gift, but Grandpa is not likely to owe any gift tax

because of the lifetime exclusion discussed later.

The federal gift tax **marital deduction** allows an unlimited amount to be transferred from one spouse to the other without triggering any federal gift tax consequences. Consequently, spouses can divide their wealth evenly between them and then each can make gifts to children, grandchildren or anyone else.

Example 13. If Dale owned all of the farm assets as individual property because he inherited them from his parents and kept them separate from his and Gwen's marital property, he could give half of the assets to Gwen without any gift tax consequences because the entire gift qualifies for the marital deduction. Dale and Gwen could then each make gifts to Bill and Carl.

Note. In Wisconsin, all property owned by a married individual is presumed to be marital property, which means each spouse owns half. A married person can own property as individual property but has the burden of proving that it is individual property. Examples of individual property include assets owned before marriage, assets received by gift, and assets received as an inheritance.

The federal gift tax **lifetime exclusion** was \$1,000,000 for gifts in 2002-2010. It was \$5,000,000 for gifts in 2011. Beginning in 2012 the amount is \$5,000,000 indexed for inflation. The \$5,000,000 exclusion allows each taxpayer to transfer \$5,000,000 of assets as taxable gifts without paying any gift tax. Because the annual exclusion is not included in taxable gifts, this means that a taxpayer can transfer \$5,000,000 in addition to the amounts that are transferred tax-free under the annual exclusion that was discussed earlier. The lifetime exclusion amount is allowed to pass tax free by providing an applicable exclusion

amount (\$1,730,800 for 2011) equal to the gift taxes on the applicable exclusion amount.

Example 14. Grandpa gave the 59 acres of farm land to Dale and the 40 acres of timber to Fran in 2011 and had made no prior taxable gifts. He owed any gift taxes but used up some of his federal gift tax lifetime exclusion as shown below.

59 acres of farmland	\$ 295,000
40 acres of timber	<u>280,000</u>
Total gifts	\$ 575,000
Minus annual exclusions	<u>- 26,000</u>
Remainder	\$ 549,000
Gift tax on \$549,000	\$ 173,930
Applicable credit	<u>- 1,730,800</u>
Gift tax due	-0-
Applicable exclusion	\$5,000,000
Taxable gift	<u>- 549,000</u>
Remaining exclusion	\$4,451,000

Wisconsin Gift Tax. Under current law Wisconsin does not impose a gift tax on gifts.

Federal and Wisconsin Income Tax. Transferring assets by gift during lifetime rather than at the time of death can have a significant adverse effect on the recipient's income taxes. The adverse effect is a result of the recipient's income tax basis in the assets.

Generally, assets that are received as a gift have the same basis in the hands of the donee as they had in the hands of the donor. The two exceptions to the general rule are gifts of assets that have a fair market value less than the donor's basis and gifts that trigger a gift tax liability. If the fair market value is less than the donor's basis, the donee's basis is the fair market value on the date of the gift for purposes of calculating the donee's depreciation and for purposes of calculating a loss upon sale by the donee. If gift taxes are due on the gift, the gift tax attributable to the appreciation in value of the asset while the donor owned it is added to the donor's basis.

Example 15. If Grandpa gave his 59 acres of farmland valued at \$295,000 with an \$11,800 income tax basis to Dale and there was no gift tax due on the gift, Dale's income tax basis in the land would be \$11,800. If the land had a \$350,000 basis and \$295,000 fair market value when Grandpa gave it to Dale, Dale's basis would be \$295,000 for purposes of calculating his loss on sale and would be \$350,000 for purposes of calculating his gain on sale.

Summary. Most Wisconsin farmers do not incur any gift tax liability because the value of their gifts does not exceed both the annual exclusion and the lifetime exclusion. However, gifting assets can have a significant effect on the donee's income taxes because the donor's income tax basis in the assets carries over to the donee. To minimize the adverse income tax effects of gifts, donors should give away property that has an income tax basis as close to the fair market value of the asset as possible. If the fair market value is significantly higher than the basis, gain is unnecessarily carried over to the donee. If the fair market value is significantly less than the basis, a deduction for the loss on sale of the property is lost.

Transfer at Death

If the farm assets are transferred at the time of death, there may be estate tax consequences. The transfer will also have an effect on the donee's income taxes because he or she will have a date-of-death value basis in the property as discussed later.

Federal Estate Tax. The federal government imposes an estate tax if the value of the taxable estate and the value of taxable gifts made during the decedent's lifetime exceed the applicable exclusion amount. To allow the applicable exclusion amount to pass tax free,

the estate tax rules provide an applicable credit amount that offsets the estate tax on the applicable exclusion amount. Under current law, the applicable credit amounts and applicable exclusion amounts for 2006 and after are:

<u>Years</u>	<u>Applicable Credit Amount</u>	<u>Applicable Exclusion Amount</u>
2006 – 2008	\$ 780,800	\$2,000,000
2009	\$1,455,800	\$3,500,000
2010* – 2011	\$1,730,800	\$5,000,000
After 2011	\$1,730,800**	\$5,000,000**

* Estates of decedents who died in 2010 can elect out of the estate tax and instead have a modified carryover basis in assets.

** The \$1,730,800 and \$5,000,000 are adjusted for inflation for deaths after 2011.

Example 16. To illustrate the calculation of gift and estate taxes, assume that in 2009, Grandpa gave the farmland to Dale and the timber land to Fran as in Example 14. Grandpa died in 2011 leaving the remainder of his assets (valued at \$4,439,550) to Dale and Fran in equal shares. His estate would owe \$5,893 of estate tax as follows:

Value of estate	\$4,439,550
Lifetime taxable gifts	<u>549,000</u>
Total	\$5,014,550
Tax on \$5,014,550	\$1,735,893
Applicable credit (in 2011)	<u>- 1,730,800</u>
Federal estate tax	\$ 5,893

Marital Deduction. Any amount passing to a spouse upon death qualifies for the estate tax marital deduction. Consequently all estate taxes can be avoided on the death of the first spouse to die by making sure that no more than the applicable exclusion amount passes to individuals other than the surviving spouse.

Example 17. If Grandpa married his dancing partner, Hazel, and bequeathed \$4,439,550 to her when he died in 2011, his estate would owe no federal estate taxes.

Wisconsin Estate Tax. The Wisconsin estate tax expired at the end of 2007. Therefore, currently there are no transfer taxes imposed by Wisconsin on transfers at death.

Federal and Wisconsin Income Tax. Transferring assets at the time of death rather than by gift during lifetime can have a significant positive effect on the recipient's income taxes. The positive effect is a result of the recipient's income tax basis in the assets.

The income tax basis in assets that are included in the decedent's estate for estate tax purposes is adjusted to the date-of-death value of the asset. This rule allows a tax-free step up in basis for assets that have a value that exceeds the decedent's basis. It also requires a step down in basis of assets that have a value less than the decedent's basis without any income tax benefit from the decrease in basis.

If the executor of estates of decedents who died in 2010 elected out of the estate tax, the assets that pass from the decedent to survivors have a modified carryover basis. Under those rules, the survivor's basis is the same as the decedent's basis except that the executor of the estate can allocate a basis increase among the decedent's assets but the basis of any asset can be increased to no more than the fair market value of the asset on the decedent's date of death. Furthermore, the aggregate increase in basis is limited to \$1,300,000 plus losses the decedent had not deducted at the time of death. For assets passing to a surviving spouse, the limit is increased by another \$3,000,000.

For marital property, the benefit of the basis rules at death is even greater. Both the half of the marital property in the decedent's estate and the half of the marital property that is owned by the surviving spouse receive a date-of-death value basis.

Example 18. Assume that Dale and Gwen made no gifts or sales of assets before Gwen died in 2015. Because Dale and Gwen owned all of their assets as survivorship marital property, Dale became the sole owner of all of the assets upon Gwen's death. Dale's income tax bases in the half he owned before Gwen's death as well as in the half he received at the time of her death are adjusted to the date-of-death value. The income tax bases before and after death are shown in the following table.

Asset	Before Death		Date of Death Value and Dale's Basis After Gwen's Death
	Dale's Basis	Gwen's Basis	
Feed	0	0	23,550
Cattle	7,000	7,000	188,400
Machinery	8,434	8,434	117,868
House	37,500	37,500	175,000
Farmland	60,000	60,000	750,000
Total	112,934	112,934	1,254,818

The increase in basis allows the individuals who own the property after the decedent's death to claim more depreciation and it reduces gain or increases losses they recognize on sale of the assets.

Example 19. Before Gwen's death, Dale and Gwen had no basis in the feed and only \$14,000 basis in the dairy herd because all of the feed and most of the animals were raised and all the costs of raising them were deducted on their income tax return. After Gwen's death, Dale is allowed to deduct the \$23,550 basis in the feed and to depreciate his \$188,400 basis in the herd over a five-year recovery period.

If Dale sold cows to Bill and Carl for their date-of-death value, he would have no gain to report. If he gave cows to Bill and Carl, they could depreciate the date-of-death value basis that carries over to them.

Observation. By contrast, if Dale and Gwen transferred the feed and cattle by gift before Gwen died, Bill and Carl would have a zero income tax basis in the feed and a \$14,000 basis in the cattle.

Summary. Most Wisconsin farmers do not incur any estate tax liability because the value of their taxable lifetime gifts and the estate left at the time of death do not exceed the applicable exclusion amount. However, passing assets at death rather than gifting them during life can have a significant effect on the beneficiary's income taxes because the beneficiary's income tax basis is adjusted to the date-of-death value. To maximize the benefit of the date-of-death basis rules, taxpayer's should hang onto assets that have the greatest difference between fair market value and basis and transfer them at the time of death. That will maximize the tax-free step-up in basis.

Trade

A farm owner can trade the farm assets for "like-kind" assets without triggering the recognition of the gain realized on the trade.

Example 20. Dale traded a tractor for a planter. The trade-in value of the tractor was \$25,000 and it had a \$2,000 basis. Dale paid \$15,000 of boot for the planter. Because farm machinery is treated as like-kind when it is traded for other farm machinery, Dale does not recognize the \$23,000 difference between the \$25,000 value of the tractor and its \$2,000 basis. Instead that gain is rolled over into the planter by giving Dale a \$17,000 basis in the planter instead of the \$40,000 basis he would have if he paid \$40,000 cash for the planter.

Farm owner's can use the like-kind exchange rules to postpone recognizing gain when they transfer their farmland if they are willing to

invest the value of the farmland in other real property. Any real estate (including buildings) that is held for use in a trade or business or that is held for investment is considered as like-kind when it is exchanged for other real estate held for use in a trade or business or held for investment.

Example 21. Grandpa could trade his 59 acres of farmland that is valued at \$295,000 for a warehouse that is valued at \$295,000 without recognizing any of the \$283,200 difference between his \$11,800 basis in the land and its \$295,000 value as taxable gain. His income tax basis in the warehouse would be \$11,800.

If Grandpa paid \$50,000 in additional to trading the 59 acres of land for the warehouse, he does not have to recognize any gain and he adds the \$50,000 of boot to the \$11,800 of basis he carried over from the 59 acres for a total of \$61,800.

If Grandpa received \$30,000 in addition to the warehouse for the farmland, he would have to recognize \$30,000 of gain from the trade. That is the lesser of:

1. the \$283,200 difference between his \$11,800 basis in the 59 acres and its \$295,000 value and
2. the cash he received in the trade.

He adds the \$30,000 gain he recognized to the \$11,800 basis he carried over from the 59 acres for a total of \$41,800 basis in the warehouse.

Note. If Grandpa owns the warehouse at the time he dies, the basis in the warehouse will be adjusted to its date-of-death value and all of the gain that he rolled over from the farm will disappear.

Taxpayers can get the like-kind exchange tax treatment without directly exchanging their property for the property they acquire. They can sell their property to one person, put the sale proceeds in an escrow account held by a

qualified intermediary and then buy their replacement property from another person with the money in that account.

Example 22. Grandpa could sell his 59 acres of farmland to Dale and have the \$295,000 sale proceeds go directly to a qualified intermediary. Grandpa could then direct the qualified intermediary to buy the warehouse. Grandpa would be treated as exchanging the 59 acres for the warehouse and could roll his gain into the warehouse as shown in Example 21.

The exchange can also be done in reverse. The replacement property can be purchased before the relinquished property is sold.

Example 23. Grandpa could place money in escrow with a qualified intermediary who buys the warehouse for him. He could later sell his farmland to Dale and treat the transactions as a like-kind exchange.

Caution. The like-kind exchange rules are complex and are strictly enforced by the IRS. Taxpayers should hire a qualified professional to guide them through the like-kind exchange before signing any purchase or sale agreements.

Transferring to a Business Entity

A farm owner can transfer farm assets to a business entity such as a partnership, a limited liability company (LLC) or a corporation and then transfer ownership of the entity to the next generation by sale, gift during lifetime or a transfer at death. In most cases, the transfer of assets to the entity does not trigger recognition of gain. The income tax consequences of a subsequent sale, gift or transfer of an interest in the entity at death are similar to the income tax consequences of transferring assets discussed earlier.

Example 24. Grandpa and Dale set up Bella Acres, LLC and transferred their feed and cattle to the LLC. The values of the assets they contributed to the LLC are as follows:

	Value of Grandpa's	Value of Dale's	Value of LLC's
<u>Asset</u>	<u>Asset</u>	<u>Asset</u>	<u>Asset</u>
Feed	\$ 23,550	\$ 23,550	\$ 47,100
Cattle	<u>130,000</u>	<u>188,400</u>	<u>318,400</u>
Total	\$ 153,550	\$ 211,950	\$ 365,500

Therefore, Grandpa owns about 42% ($\$153,550 \div \$365,500$) of the LLC and Dale owns about 58% ($\$211,950 \div \$365,500$) of the LLC.

The transfer of the assets to the Bella Acres, LLC does not trigger recognition of any gain. Grandpa's and Dale's income tax bases in the assets are carried over to Bella Acres Farms, LLC as follows.

	Grandpa's	Dale's	LLC's
<u>Asset</u>	<u>Basis</u>	<u>Basis</u>	<u>Basis</u>
Feed	\$ 0	\$ 0	\$ 0
Cattle	<u>0</u>	<u>14,000</u>	<u>14,000</u>
Total	\$ 0	\$ 14,000	\$ 14,000

Grandpa has a zero income tax basis in his interest in Bella Acres, LLC and Dale has a \$14,000 basis in his interest in Bella Acres.

A sale of assets by the entity triggers recognition of gain.

Example 25. If Bella Acres Farms, LLC sells a raised dairy cow for \$1,000, it must report all of the \$1,000 as gain because the cow has a zero basis carried over from Grandpa or Dale. The LLC does not pay tax on that gain. The gain is included in the income of the members of the LLC on their individual income tax return.

A sale of part or all of a membership interest will trigger recognition of gain by the seller.

Example 26. If Grandpa sold a 10% interest in Bella Acres, LLC to each Bill and Carl for \$36,550, he would recognize \$73,100 ($\$36,550 \times 2$) of gain because his basis in his LLC interest is zero. Bill and Carl each have a \$36,550 basis in the 10% LLC interests that they purchased.

A gift of a membership interest qualifies for the annual exclusion and the value of the gift in excess of the annual exclusion is a taxable gift that uses up the donor's lifetime exclusion. The donor's basis in the membership interest is carried over to the donee.

Example 27. If Grandpa gave a 10% membership interest in Bella Acres Farms, LLC to each Bill and Carl in 2013, he would use up \$45,100 of his lifetime gift tax and estate tax exclusion as follows:

Value of 20% membership	\$73,100
Annual exclusion	<u>- 28,000</u>
Taxable gift	\$45,100

Carl's and Bill's income tax basis in their 10% interests in Bella Acres, LLC is zero because they acquire Grandpa's zero basis in those interests.

Transferring a membership interest at death causes the value of the membership interest to be included in the decedent's estate. The beneficiary's income tax basis in the membership interest is its date-of-death value.

Example 28. If Grandpa died soon after he and Dale set up Bella Acres, LLC and left a 10% interest in the LLC to each Bill and Carl, Bill and Carl would each have a \$36,550 basis in their 10% interests in the LLC.

Conclusion

There are many alternatives for transferring farm assets from one generation to the next. No one method is right for all farm owners. Most farm owners have several different options that will work for transferring their farm so they need to determine the tax and other consequences of each option and then decide which option is best for them.

Exercise:
Tax Implications

Using Bella Acres as an example, have each group select a method of transferring listed assets to the younger generation and determine the tax consequences of the transfer.

Method of Transfer

Taxes

1. Feed Inventories

2. Dairy Herd

3. Machinery

4. Real Estate



Bella Acres *Snapshot*

Dale farms with his father, Grandpa, who did not remarry after his wife died. Dale and his wife Gwen have a marital property agreement that says everything they own is marital property with right of survivorship. Therefore, any assets titled in the names of either Dale or Gwen individually as well as property titled in both of their names is marital property with right of survivorship. Dale and Gwen's sons, Bill and Carl, want to join the farming business. Dale's sister, Fran, rents land that she owns to the farming business. The following is a snapshot of the assets used in the farming business. It shows the fair market value of assets, the income basis of assets and the outstanding debts.

Livestock

- 95 registered Holstein home bred cows valued at \$2,000/cow
- Milked 2x, DHI rolling herd average 24,000#, 21,600# shipped/cow, SCC 100,000
- 46 bred heifers valued at \$1,800/hfr.
- 28 open heifers valued at \$1,200/hfr
- 20 heifer calves valued at \$ 600/calf
- Bull calves are sold within 7 days of birth.
- Replacements are raised from home stock.

Livestock Housing

- 85 tie stall barn, added onto four separate times, attached second barn provides housing for remainder of milking cows, dry cows, bred heifers.
- Three-sided shed for open heifers and calves are housed in individual calf hutches inside shed.

Feed Storage

- 2 concrete silos, 1 Harvestore for forage, and 1 Harvestore for high moisture grain.
- Baled hay and straw is stored in barn haymow.
- It takes 9-10 hours/day to mix TMR, feed, clean barn and milk

Manure Storage

- Earthen lagoon pit with 9-month storage capacity for 95 cows, which is emptied spring and fall.

Machinery

- Adequate, but old; haybine, baler, chopper need to be replaced.
- Purchased a used skid steer this year for \$8,868.

Land Base

- Bella Acres now consists of 400 total acres.

<u>Grandpa</u>	<u>FMV</u>	<u>Basis</u>
59 acres of farmland	\$295,000	\$ 11,800
40 acres of timber	\$280,000	\$ 8,000
Cabin	\$ 70,000	\$ 25,000
10 acres farmstead	\$ 50,000	\$ 2,000
House on farmstead	\$150,000	\$ 30,000
Barn	\$ 0	\$ 5,000
Machine Shed	\$ 5,000	\$ 7,000



<u>Dale</u>		
150 acres farmland	\$750,000	\$120,000
House on farmstead	\$175,000	\$ 75,000

Fran
141 acres rented to the partnership.

- Timber includes a perennial stream and cabin.
- Bella Acres farm lies within four miles of Metropolis, a metropolitan region with 20,000 population, and is within a mile of a small subdivision (5 houses currently).
- Fran’s 141 acres lies on the other side of Metropolis and Bella acres.

Crop Rotation and Yield

- 98 acres corn for grain @ 98 bushels/acre
- 53 acres corn for silage @ 14 wet tons/acre
- 95 acres established alfalfa @ 3 tons dry matter/acre
- 40 acres oats/new seeding @ 1 ton dry matter/acre

Financial

- Net worth growth has been slow, but very good equity.
- Grandpa’s land does not have a lien on it.
- Rates of return on assets and equity have been historically low.
- Year-end loan balances, rates, terms.
 - Line of credit \$5,000.
 - Machinery loan \$93,129 @ 7% @ 5 years remaining @ \$2,000/month
 - Principal paid - \$16,871; Interest paid - \$7,129
 - Real Estate Loan \$174,634 @ 6.5% @ 8 years remaining @ \$2,700/month
 - Principal paid - \$20,366; Interest paid - \$12,034

Off-Farm Income

- Gwen earns \$23,000/year at the local bank. She receives full health and dental benefits for the family.
- During the summer Dale earns about \$2,000 net income buying and selling cattle for others.

Farm Business Arrangement

- Grandpa and Dale operate their farming business as a 50-50 partnership that does not own any assets other than the crops and milk that it produces..

○ Grandpa’s Machinery	<u>FMV</u>	<u>Basis</u>
▪ Chopper	\$5,000	\$ 0
▪ Baler	\$2,000	\$ 0
▪ Haybine	\$4,000	\$ 0

- Dale’s Machinery FMV is \$117,868. This includes this year’s purchase of a skid steer for \$8,868. Basis in Dale’s machinery is \$16,868 including the skid steer.
- Grandpa owns 65 cows that have a \$130,000 fair market value and a zero income tax basis because they were raised. Dale owns 10 cows that he bought. They are worth \$20,000 and have a \$14,000 income tax basis. He owns 20 raised cows, which are worth \$40,000, and all of the youngstock, which are worth \$128,400 and have a zero basis because they are all raised.
- The partnership has \$47,100 of raised feed in the bin.

Bella Acres February 2009