Tax Considerations of Farm Transfers

AAE 320

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Goal

- To understand the options for transferring farm assets from one generation to the next and the tax consequences of each option
- *Most of these options and rules apply to non-farm assets as well*

Alternatives for Transferring Farm Assets (p. 1)

- 1. Sale
- 2. Gift
- 3. Transfer at death
- 4. Trade
- 5. Transfer to a business entity

Taxes paid by Farmers

- Property (real estate) taxes
- Sales taxes
- Employment taxes
- Income taxes
- Self-employment taxes
- Gift taxes
- Death (estate) taxes

Our focus in AAE 320

1: Sale

- Seller has no gift or death tax consequences
- Seller likely has income tax and self-employment tax consequences
- Depends on the amount of this <u>Gain</u> (or loss) and the <u>Character of this Gain</u>
- Gain = Amount seller recognizes from sale minus seller's tax basis in the asset
- Typically means sales price – tax basis

Example 1: Land p. 1

- Sale Price $295,000
- <u>Basis $11,800</u> ← Original purchase price
- Gain $283,200

- Basis for land is the original purchase price

Example 2: Cows pp. 1-2

- Sale price of cows $130,000
- <u>Income tax basis $0</u>
- Gain $130,000

- No basis in raised farm assets, owner gets to deduct annual costs of raising them each year

Example 3: Machinery   p. 2

- Sale price $58,934
- <u>Basis - $8,434</u>
- Gain $50,500

- Basis is the value remaining after tax depreciation deductions taken

Character of Gain (or Loss)

- Different types of gains are subject to different types of taxes
- This is called the Character of the Gain
- Ordinary income (10% - 37%)
- Capital gain (0% - 20%)
- Self-employment income (15.3%)

Self-Employment Tax
Example 4, p. 2-3

- Normally employer & employee split this tax, but if self-employed, must pay both halves
- Mix of Social Security and Medicare taxes
- Social Security tax is 12.4% of first $128,400 of self employment income earned in 2018 (the max earnings amount is inflation indexed)
- Medicare: 2.9% of self employment income, with more if income above certain levels
- 12.4% + 2.9% = 15.3%

Three categories of gain p. 3

- i: Subject to ordinary income tax and to self-employment (SE) tax
- ii: Subject to ordinary income tax, but not to SE tax
- iii: Capital gain or ordinary loss

i. Subject to ordinary tax rates and to self-employment (SE) tax

- Gain from sale of assets “held for sale in the ordinary course of business”
- Most common: grain, feeder livestock, milk
- Gain from calves is subject to ordinary income tax and SE tax (but not gain from sale of heifers and cows)

ii. Subject to ordinary income tax, but not SE tax

Common examples

- Depreciation recapture
  - Example 6, p. 3
  - Avoid SE tax (15.3%) on gain when resell machinery if use Section 179 to deduct full cost of machinery as depreciation when purchased
- Gain from sale of <u>young</u> breeding stock
  - Example 7 (p. 3-4)
  - Young is defined in tax law: a 12-24 month holding period required

iii. Capital gain or ordinary loss

- Capital gain tax rates lower than income tax rates (creates incentive to invest)
- Assets like land, buildings, <u>breeding</u> livestock
- Short-term gains for assets held less than 1 year treated as ordinary income
- Example 8 (p. 4)
- Capital Gains tax rate depends on your taxable income, small changes in 2018

Taxable Income (single)	Taxable Income (married filing joint)	Cap Gains Rate
< $38,600	< $77,200	0%
$38,601 to $425,800	$77,201 to $479,000	15%
>$425,800	>$479,000	20%

iii. Capital gain or ordinary loss

- In 2013: Net Investment Income Tax (NIIT) of 3.8% was imposed on investment income if your AGI > $200,000 ($250,00 MFJ)
- Farm assets are not subject to the tax, but a land sale can push your AGI above the limit so that other investment income becomes subject to this tax (Ex. 9, 4-5)
- Installment sales can reduce both capital gains and income tax rates (Ex. 10, p. 5)
  - Can also help with NIIT tax

2: Transfer by Gift

- Second way to transfer farm assets between generations is to give them away
- The donor may have to pay gift taxes
- <u>Rarely</u> the case because of annual and lifetime exclusions for gift taxes
- Annual exclusion: $15,000/year in 2018 (indexed)
- Marital deduction: unlimited
- Lifetime exclusion: $5,600,000 in 2018 (indexed)
- Examples 11-15, pp. 5-7

Transfer by Gift: Caveats

- Gift allows donor to mover assets and avoid taxes: give $15,000 annually from Grandpa and from Grandma to Child and to Spouse = $60,000
- Income Tax Basis Transfers with the Gift
  - Exception: cannot gift a Loss, if basis > fair market value (FMV), then donee's basis becomes the FMV
  - If donor does not pay gift taxes, then added to basis
- If the recipient sells the assets, the gain becomes subject to taxes, depending on the character of the gain

3: Transfer at Death

- A. Estate tax consequences
- B. Income tax consequences
- Federal Estate Tax Exclusions: $5,600,000 in 2018 (inflation indexed)
  - Example 16: same exclusion as the lifetime gift tax exclusion: $2,117,800
  - No Wisconsin estate tax

3: Transfer at Death

- Assets passing at death to spouse receive an income tax basis equal to the date-of-death fair market value (FMV)
- Both halves of marital property get a date-of-death value basis
- Death of spouse can greatly reduce tax liabilities for surviving spouse
- Examples 17-19

Example 18

Asset	Dale's Basis	Gwen's Basis	After Gwen's Death
Feed	0	0	23,550
Cattle	7,000	7,000	188,400
Mach.	8,434	8,434	117,868
House	37,500	37,500	175,000
Land	60,000	60,000	750,000
Total	112,934	112,934	1,254,818

Gain = Selling Price – Basis, but if Basis = FMV, there is no Gain

4: Trade

- Owner can trade farm assets for like-kind assets
- Does not eliminate the gain and potential tax liabilities, just changes ownership
- Trade does not trigger <u>recognition</u> of the gain
- See examples 20 and 21
- Be careful, IRS watches these like-kind exchanges: Hire a good lawyer

5: Transfer to a Business Entity Examples 24-27

- Similar to a like-kind trade: Owner can transfer farm assets into a different entity (e.g., LLC)
- Next generation can now use the farm assets if they are also part of the business
- Does not eliminate the gain and potential tax liabilities
- Transfer in does not trigger recognition of gain
- Gift, sale, and death tax consequences still generally the same

Summary

- 5 ways to transfer farm assets to next generation: Sale, Gift, Transfer at death, Trade, and Transfer to a business entity
- Key Concepts:
  - How to calculate Gain
  - Basis and events that cause change of Basis
  - Character of Gain
  - Events that cause Recognition of Gain
- Taxes to consider: Ordinary income tax, Capital gains tax, Self-employment tax, Gift tax, and Estate tax