Tax Considerations of Farm Transfers

AAE 320
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Agricultural & Applied Economics

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Learning 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 also apply to non-farm assets
Alternatives for Transferring Farm Assets

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 (p 1)

- Seller has no gift or death tax consequences
- Seller likely has income tax and self-employment tax consequences
- Depends on the amount of this **Gain** (or loss) and the **Character of this Gain**
- 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
- Basis $11,800
- Gain $283,200

- Basis for land is the original purchase price
Example 2: Cows (p 1-2)

- Sale price of cows $130,000
- Income tax basis $0
- 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
- Basis - $8,434
- 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: $132,900 in 2020
- 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 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
• Gain from sale of heifers & cows does **not** fall into this category
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 young 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, breeding 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

<table>
<thead>
<tr>
<th>Taxable Income (single)</th>
<th>Taxable Income (married filing joint)</th>
<th>Cap Gains Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; $40,000</td>
<td>&lt; $80,000</td>
<td>0%</td>
</tr>
<tr>
<td>$40,001 to $441,450</td>
<td>$80,001 to $496,600</td>
<td>15%</td>
</tr>
<tr>
<td>&gt;$441,450</td>
<td>&gt;$496,600</td>
<td>20%</td>
</tr>
</tbody>
</table>
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 ($250,000 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 (Example 9, p 4-5)

• Installment sales can reduce both capital gains and income tax rates (Example 10, p 5)
  • Can also help with NIIT tax
2: Transfer by Gift

• The donor may have to pay gift taxes, but this is rarely the case because of annual and lifetime exclusions for gift taxes
• Annual exclusion: $15,000/year in 2018 (indexed)
• Marital deduction: unlimited
• Lifetime exclusion: $11,400,000 million in 2018 (indexed), $22,800,000 million if married filing joint
• If you give someone $50,000, file gift tax form: claim the $15,000 annual exclusion and $35,000 of your lifetime exclusion
• Gift tax rates: 18% to 40%
• Examples 11-15, p 5-7 (older exclusion values, change in 2018)
Transfer by Gift: Caveats

• Gift allows donor to move 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: $11,200,000 (indexed), changed for the 2018 law, so reading out of date on value
- Estate pays 40% flat rate on amounts exceeding the lifetime exclusion level
  - 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 the surviving spouse
• Examples 17-19
Example 18

<table>
<thead>
<tr>
<th>Asset</th>
<th>Dale’s Basis</th>
<th>Gwen’s Basis</th>
<th>After Gwen’s Death</th>
</tr>
</thead>
<tbody>
<tr>
<td>Feed</td>
<td>0</td>
<td>0</td>
<td>23,550</td>
</tr>
<tr>
<td>Cattle</td>
<td>7,000</td>
<td>7,000</td>
<td>188,400</td>
</tr>
<tr>
<td>Mach.</td>
<td>8,434</td>
<td>8,434</td>
<td>117,868</td>
</tr>
<tr>
<td>House</td>
<td>37,500</td>
<td>37,500</td>
<td>175,000</td>
</tr>
<tr>
<td>Land</td>
<td>60,000</td>
<td>60,000</td>
<td>750,000</td>
</tr>
<tr>
<td>Total</td>
<td>112,934</td>
<td>112,934</td>
<td>1,254,818</td>
</tr>
</tbody>
</table>

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 recognition of the gain
• See examples 20 and 21
• Be careful, IRS watches these like-kind exchanges: Hire a lawyer to be sure you do it right
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