Tax Considerations of Farm Transfers

AAE 320

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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 <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 **Gain = Sale 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 (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
- Three types of taxes to consider
  - 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
- Generally sale of current assets
- Gain from calves is subject to ordinary income tax and SE tax
- Gain from sale of heifers & cows does <u>not</u> fall into this category

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

Common examples: Sale of specific types of non-current assets

- 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 less than income tax rates: (incentive to invest)
- Assets like land, buildings, breeding livestock
  - Generally most non-current assets, except those in 2nd category
- Short-term gains for assets held less than 1 year are treated as ordinary income
- Example 8 (p. 4)
- Capital Gains tax rate depends on your taxable income

Taxable Income (single)	Taxable Income (married filing joint)	Cap Gains Rate
< $40,000	< $80,000	0%
$40,001 to $441,450	$80,001 to $496,600	15%
>$441,450	>$496,600	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 ($250,000 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: $11,400,00 million in 2018 (indexed), $22,800,000 million if married filing joint
- If you give someone $50,0000, 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, changed in 2018)

Transfer by Gift: Caveats

- Gift allows <u>donor</u> 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 (recipient's) basis becomes the FMV
  - If donor does not pay gift taxes, then added to basis
- If the <u>recipient</u> 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

Asset	Fair Mkt Value	Dale's Basis	Gwen's Basis	Dale's Basis After Gwen Dies
Feed	23,550	0	0	23,550
Cattle	188,400	7,000	7,000	188,400
Mach	117,868	8,434	8,434	117,868
House	175,000	37,500	37,500	175,000
Land	750,000	60,000	60,000	750,000
Total	1,254,818	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 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
  - 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