UNIVERSITY OF MINNESOTA | EXTENSION

Transferring the Farm Series #7 8/2017

Tax Considerations When Transferring Assets

Agricultural Business Management

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Income Tax Basis:

When selling an asset, you pay tax on the difference between the selling price and your adjusted basis (cost plus improvements minus depreciation) of the asset.

Example: If you sell land for $100,000 and your adjusted basis for the land is $20,000, your taxable gain is $80,000.

Adjusted basis is your cost to recover when you sell the asset. This adjusted basis is determined by how you acquired the asset.

If you purchased the asset:
Generally, your basis is what you paid for the asset, plus improvements, minus any depreciation you've claimed on the asset.

Examples:
1) If you purchase a tractor for $120,000 and depreciated it for 3 years claiming a total of $42,850 depreciation, your adjusted basis would be $77,150 (assuming no improvements).

2) If you purchased land and have claimed no depreciation on it, your basis is what you paid for it, plus any improvements (tiling, etc.).

If you inherited an asset:
Your basis is the Fair Market Value (FMV) or Special Use Value assigned the asset as it passed through the estate to you.

Example: You inherited some land from your mother. Her adjusted basis was $70,000. Upon her death, the land received a step up in basis and is valued in her estate at $160,000. Your adjusted or cost basis is $160,000.

If you received an asset as a gift:
Generally, your basis is the same as the adjusted basis of the donor.

Example: You received a gift of farmland valued at $160,000 with a basis (purchase price) to the donor of $25,000. Your basis is then $25,000.

Asset basis is extremely important to the property holder since it determines the amount of tax that will be paid upon the sale of the asset.

Assets that pass through an estate receive a "stepped up" basis. The "stepped up" basis is usually the fair market value on the decedent's date of death. This provides a strong incentive to hold low basis property until death to achieve the stepped up valuation for heirs.

Example: Sally Smith sold 160 acres of farmland for $4200/acre or $672,000. It had an adjusted basis of $100,000. Her taxable gain whether sold for cash or by installment method would be $572,000. Because of the sale, she or her heirs must pay tax on the $572,000 gain. However, if Sally had retained the property until her death, the estate would assign a stepped up basis to FMV of $672,000. The heirs could later sell the property for that amount and pay no tax.

Personal residence:

If you sell your farm, which includes your personal residence, up to $250,000 per individual ($500,000 for married filing jointly) of the gain on the residence portion may be excluded from taxation. To qualify for the full exclusion, you must have owned and occupied the residence for at least two out of the five years before the sale. Property held under 2 years may qualify for a partial exclusion under certain conditions.

Homestead Classification:

Rural residence and ag land both qualify for the Minnesota homestead classification. Rural residence includes the home, garage and one acre of property. For ag land only, qualifying owners who live on the farm or in the house on the farm can receive reduced real estate tax payments due to Minnesota homestead classification. Farm owners who have a qualified family member operating their farm may qualify for a double homestead classification - one on their personal residence and a second on the farm. Distance limits as well as dollar and acre limits apply to the designation. If you place your land and buildings, previously classified as homestead, into a trust or any of the other MN business entities, you will have to reapply for homestead classification. If both husband and wife have their own trust with land separated into each trust, both cannot qualify for homestead classification. Husband and wife having one trust with all the land in that trust with each having an undivided interest in the land qualifies them for homestead classification on all the land. Maintaining homestead classification until death is one of the criteria for qualifying for the MN estate tax exclusion on qualified small business property qualified farm property.

For more specific details on this issue see *Transitioning the Farm Series #12-Maintaining Farm Land Homestead Classification and Qualification for Minnesota Qualified Small Business Property Qualified Farm Property Exclusion.*

Check with your county assessor for more details. They have final say on homestead classification.

Installment Sales:

Many farmers opt to report sales of property on the installment method. This allows the taxation to be spread out proportionally over the years that principal payments are made. This option may be useful to keep as many dollars in the lower tax brackets as possible. Using installment reporting late in life on low basis assets may not be wise since no stepped up basis is received on installment contracts. Heirs must continue to pay the income taxes on principal and interest payments when the asset passes to them. Most items can be sold using the installment method. Any gain, to the extent of depreciation on equipment and all other Sec. 1245 property as well as depreciable business property sold to related parties, will not qualify for installment tax treatment.

Tax Free 1031 Exchange:

If the entering generation owns tradable property, a like-kind tax-free exchange might be used to transfer farmland or buildings. This is a complicated tax issue but can aid in moving the younger generation onto the home farm. Using the tax free exchange can avoid or postpone taxation of the parents' capital gains on low basis property. Rules for IRS 1031 state that you have 45 days to locate a like-kind piece of property, 180 days to close the transaction and you cannot take possession of any funds that are involved - the funds must go through an intermediary such as a realtor.

Caution: make sure your attorney and accountant communicate regarding this type of transaction so no detail is overlooked. Non-compliance can result in forfeiture of the transaction and tax consequences.

Spread Out Income:

As a farmer retires and sells off his or her assets, a large income and self-employment tax bill emerges. It may be wise to plan ahead and spread the final sales over a two, three or more year period. Leveling income usually results in lower taxes paid compared to bunching income into one year.

Capital Gains:

Long-term federal capital gains tax rates are currently 0%, 15%, 20%, 25% and 28%.

For those in the 10 & 15% federal tax bracket, capital gains tax rates are 0% on any gain included in taxable income totaling less than the maximum for the 15% federal tax bracket. Capital gain amounts in excess of the maximum federal income tax bracket will be taxed at 15%. Assets included in this calculation include stocks, bonds, and land held longer than one year, as well as some raised breeding stock. **Rates are subject to change!**

Example: John & Jane Sample sell land with a capital gain total of $60,000. Their taxable income without the gain is $45,300. They can add $30,000 of the $60,000 to their income bringing the total to $75,300 (top of 15% federal tax rate for 2016) and pay 0% federal capital gain tax on $30,000 of gain. The remaining $30,000 of gain is taxed at 15%. Gain amounts in excess of the top of the 15% federal income tax bracket will be taxed at the 15% rate. Gain above the new 2013 federal income bracket of 39.6% will be taxed at 20%. Farm building sales are taxed at 25%. Gain on collectables is taxed at 28%.

Capital gains in Minnesota are taxed at ordinary income tax rates: 5.35%, 7.05%, 7.85% or 9.85%.

Note: Sales of capital assets may be subject to the new Medicare Surtax which is part of the Affordable Care Act of 2010 taking effect January 1, 2013. See description on next page for more details. Consult with your accountant and attorney for the best strategy for minimizing the tax consequence of any transaction or if the rules have changed.

Income Averaging:

Income averaging allows farmers to spread their income in a high income year over the past three years which may have been lower income years. This can significantly reduce taxes paid in a high-income year. Income averaging does not affect self-employment tax on either the current or previous years. Income averaging applies to ordinary (Schedule F, Form 1040) farm income as well as gain from the sale of assets used in the farming business except from the sale of land or timber. It also applies to an owner's share of net farm income from an S corporation, partnership, or limited liability company and wages received by an S corporation shareholder from the S corporation.

Self-Employment (SE) Tax:

If you have contributed to the Social Security (SS) system at a high level during your lifetime, you may be considering retirement before your Full Retirement Age (FRA) to begin drawing SS benefits. This would result in a reduced monthly benefit compared to retiring at your FRA. However, it might take many years of higher benefits to offset drawing reduced benefits for several additional years. In addition, farmland rental income is not subject to SS taxes. Not retiring early could cost you more per year due to not collecting monthly benefits and having to pay added tax on SE income.

However, if you have contributed to SS on a low level of earnings during your lifetime, it may be advantageous to delay retiring until your FRA. Hopefully during these last few years you can build your benefit package by making larger contributions to SS. High earnings and high contributions could have a significantly positive effect on your Social Security benefits.

This is a complicated issue but also a crucial issue to you and your farm business transfer and retirement planning. Seek advice from a qualified Social Security representative.

Medicare Surtax Provisions:

As a result of passage of the 2010 Affordable Health Care Act (ACA), there will be two new Medicare tax increases that will apply to higher income individuals. These new taxes could affect someone liquidating land, machinery or other farm assets depending upon their situation. The new taxes take effect January 1, 2013. Tax income threshold amounts are as follows:

- Married filing jointly - $250,000
- Married filing separately - $125,000
- Single - $200,000
- Head of Household - $200,000
- Trusts & Estates - $11,950

The tax increases apply to earned/active income and unearned/passive income. The thresholds are no indexed for inflation.

Earned/Active Income: First is an increase in the former 2.9% Medicare tax equal to 0.9%. That will result in a total maximum tax rate 3.8%. The increase applies to earned/active income which includes self-employed income, farming wages as well as non-farm income. The tax applies **only** to taxpayers with income above the threshold amounts list above.

Income is classified as earned/active income if the income is from farming or a business where the farmer/owner has material participation. There are several criteria for determining if the farmer has qualified for material participation.

Material participation criteria include:

- More than 500 hours spent participating in the farm business.
- Farmer's participation in farming activity represented substantially all of the total participation of all persons who participate.
- Farmer participated more than 100 hours and more than anyone else in the activity for the year.
- Farmer participated on a regular and continual basis during the year based on all facts and circumstances.
- If done regularly & continuously, a farmer who makes independent management decisions for the farm is generally considered to materially participate (crop rotation, buy or sell grain, manage labor, etc.).
- Participation of the farmer's spouse will count toward material participation in the business.

Material participation must be determined each and every year. If material participation is met and the taxpayer's income ***is above*** the applicable threshold amount, the amount above the threshold amount is subject to the additional 0.9% Medicare tax. If the taxpayer's income ***is not above*** the threshold amount, their income is not subject to the additional 0.9% Medicare tax.

Unearned/Passive Income: Second is a new tax applicable to unearned or passive income. The tax rate is 3.8% for amounts over the threshold amounts. This tax is imposed upon what the law refers to as new investment income for certain individuals, estates and trusts. Threshold amounts are the same as listed earlier in this section.

Net investment income includes the following:

- Gross income from interest, dividends, annuities, royalties and rents.
- Gross income derived from businesses that are passive activities (includes land rent).
- Gross income derived from businesses trading financial instruments or commodities.
- Net income from disposition of property taken into account in computing taxable income (net capital gain from the sale of property or assets, including farm assets, if not used in trade or business). This could affect someone selling land.

A passive activity is a trade or business where you do not materially participate. For example, you no longer farm but rent your land to your son, daughter, or a neighbor. This is a passive activity. Another example is if you owned a hardware store with an apartment above the store. You rented the business and the apartment to your niece or nephew and collected rent from them. This is also a passive activity. The only way renting the store and apartment would not be a passive activity is if you were in the real estate rental business - that would qualify the income as earned/active income because you were conducting your real estate rental business.

With regard to passive income, there is an exception for farmers. A farmer who materially participated in the farm operation for 5 years in the 8 year period before the farmer begins to draw Social Security are exempt from the 3.8% surtax on the sale of farm assets.

One additional issue is that capital gain from the sale or liquidation of a closely held C corporation, even though the taxpayer may have materially participated, is subject to the 3.8% Medicare surtax. Because this is a complicated area and this can affect farmers selling farm assets, check with your attorney or accountant for information specific to your situation.

Note: With changes in federal governmental elected officials these laws can change quickly. Make sure you check with your attorney and accountant for up to date information or information specific to your situation!

Caution: This publication is offered as educational information. It does not offer legal advice. If you have questions on this information, contact an attorney.