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Farm Transition and Congressional Tax Reform

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In this issue, Guido van der Hoeven examines income tax obstacles to farm succession and transition prior to death — and presents the proposals he offered in April to the House Committee on Agriculture, which might be undertaken as part of tax reform.

When farmers retire, they typically want to see the business they worked to create passed on to the next generation intact. Current tax law creates impediments by raising the cost — sometimes to the point that those transfers do not occur.

Total wealth in farm businesses exceeds $3 trillion, according to the U.S. Department of Agriculture. However, the assets which make up farmers' wealth tend to be different than the assets of other types of businesses. A large portion of farm wealth is in an appreciating asset — land — which tends to raise the cost of entry into the agricultural industry.

An important challenge facing policymakers seeking to encourage production agriculture is smoothing the transfer of farms to a new generation looking to begin careers in farming.

This spring, Congress began hearings to explore and address tax reform. This paper is a synopsis of testimony the author presented to the House Committee on Agriculture on April 5, 2017. In September 2017, the GOP rolled out its Unified Framework for Fixing our Broken Tax Code. Congressional debate and action regarding tax reform will be forthcoming, with many interests — including production agriculture — expressing views and analysis.

The Challenge of Succession/Transition

Production agriculture is, and has historically been, a capital intensive business. Financing the acquisition of land, equipment and livestock

Problems of an Aging Population

The farm population is old and getting older. According to the 2012 Census of Agriculture, the most recent data available, the average age of farmers in the United States increased to nearly 58 in 2012, up from 50 in 1974. It is estimated that the net worth in the hands of individuals and non-profit organizations is $93 trillion (Steverman, 2017). Of this $93 trillion, it is estimated that Baby Boomers hold $30 trillion of this wealth, expected to be transferred at the rate of $1 trillion per year — or $1.9 million per minute — over the next 30 years (Sigalos and Walsh, 2017).

is a daunting challenge to a new generation of farmers. An impediment to transferring farm assets during an exiting farmer's lifetime is the increased income tax liability resulting from lifetime transfers of those assets compared to transfers after the exiting farmer's death.

If an exiting farmer sells assets to a beginning farmer, the selling farmer must recognize and pay income tax on the gain from that sale. On the other hand, if the exiting farmer gives the assets to the beginning farmer at no charge, the beginning farmers receives a carryover income tax basis in the assets and must pay tax on the donor's unrealized gain upon a subsequent sale.

By contrast, if the exiting farmer holds on to the assets until he or she dies, the heir's income tax basis in the assets are adjusted to the date-of-death value of the assets and no one has to pay income tax on the difference between the exiting farmer's basis and the date-of-death fair market value of the assets. However, doing so precludes the farmer from paying for his or her retirement out of the sale of the farm.

Agriculture is unique in that its largest asset, land, is an asset that typically appreciates in value, resulting in a large capital gain upon sale. Raised livestock also have built-in gains from the increase in numbers and value per head over time. Depreciated operating assets such as purchased livestock and machinery have little to no income tax basis as the exiting generation begins to consider retiring from the business of farming. The current tax rules encourage farmers to hold on to these assets until they die so that the income tax basis in the assets adjusts to the date-of-death value and no one is required to pay income tax on the gain.

Case Study: Two Farmers. Two Approaches. Same Problem.

Earlier this year, the author visited two North Carolina farm families in the process of retiring from active farming. For both families, the task is to find a way to move forward to fund their retirement years.

Farmer One is 70 years old. He has no family successor, but he has identified a young farmer in the area to take over his operation. Initially, the plan was to sell 2016's crop and machinery line to the successor in 2017; doing so would result in about $1.2 million of income and a $490,000 tax bill. Given the size of this tax bill, Farmer One may now delay because he feels he "can't afford" to retire. Farmer One is considering 5 or more years of farming to manage and reduce his tax bill upon retirement.

Farmer Two is 68 years old. He farms with two sons, using multiple entities which are part of his and his sons' estate and succession plans. While accomplishing goals of estate planning, transition of management, and operation of the farm, the family has incurred great expense to create and operate these entities — in large part to manage a tax bill.

Both farmers have engaged in allowed tax deferral over a lifetime of farming. And for both, a large tax bill now looms as a formidable barrier to exit preventing the younger generation from being able to fully grasp the throttle of the farm business.

The following proposals, offered by the author during Congressional testimony, would change the tax incentives for exiting farmers to encourage them to transfer farm assets during their lifetimes, rather than waiting to transfer them at their death. The ultimate goal of tax reform proposals, which is supported by these two farm family's stories, is to provide incentives to allow for aging farmers to transfer farm land and production assets to beginning farmers within their lifetime, while at the same time assuring a continuity in the productivity and profitability of the farm business. Doing so allows the retiring farmer to generate a retirement income stream with a manageable income tax liability, as well as easing the financial burdens on beginning farmers when purchasing the farm business.

1) Create an Incentive to Sell Farming Assets Before Death

Under this proposal, exiting farmers are allowed to put part or all of the proceeds from selling farm assets into a tax deferred Farm Retirement Account (FRA). The gain on sale proceeds that are placed in the FRA are not taxed until they are withdrawn. At the time of the farm sale, the capital and ordinary gains on the proceeds placed in the FRA would be calculated but not recognized. As money is withdrawn from the FRA, the capital and ordinary gain from the farm sale and the income earned by the account would be recognized. The owner and beneficiaries of the FRA could be required to withdraw minimum distributions similar to current retirement accounts.

The FRA provides an income stream for the retired farmer and defers income taxes on the gain from the sale of farm assets until the exiting farmer receives sale proceeds as a FRA distribution. Ultimately, the retirement account is consumed and the income tax paid by either the retired farmer or beneficiaries.

An alternative to the one described above is to allow "super funding" of an IRA through a farm sale. Under this alternative, the retiring farmer may sell a farm at fair market value; however, the tax consequence of the farm's sale would be based on a special use value under I.R.C. § 2032A rules. The exiting farmer can use the difference between the fair market sale price and the section 2032A special use value — up to $1,120,000 in 2017 — to "super fund" an IRA. The retiring farmer would withdraw distributions from this IRA under the distribution rules currently in place for IRAs. Again, this provides an incentive to transition land to beginning farmers while allowing a portion of the tax consequence of the sale to be paid over a period of time, and at the same time ensuring that the retired farmer has income to provide for his or her needs.

2) Alter Rules Regarding Installment Sales

Under current federal income tax law, a retiring farmer can report the gain from selling farming assets as he or she receives installment payments for them. However, the seller must recognize all the depreciation recapture from the installment sale of assets in the year of the sale. If the seller dies before the end of the installment contract, the gain from the installment sale that was not recognized by the seller before death must be recognized by the seller's estate or heirs when the remaining contract balance is paid or forgiven. By contrast, if the seller had retained ownership of the farming assets until death, the income tax basis in the assets would be adjusted to their date-of-death value and no one would recognize and pay income tax on the difference between the seller's basis in the assets and the value of the assets on the date of death.

Tax reform could amend the installment sales rules to encourage sales of farm assets before death. Installment sales provide the dual advantage of providing retirement income to the exiting generation and allowing the entering generation to use farm profits to make payments for purchased farm assets.

Proposed changes are as follows:

a) Allow retiring farmers to use installment reporting for depreciation recapture on the sale of assets that were used in the farming business. This would allow the exiting farmer to sell and receive installment payments for machinery, purchased breeding, dairy or draft livestock, and buildings without triggering an acceleration of recognized gain.

b) Allow step-up in the basis of the installment contract for the sale of these farm assets to the value of the contract on the date of the selling farmer's death. This would allow the exiting generation to make use of installment sales without losing the full benefit of the tax-free step-up in basis at death.

3) Alter Tax Reporting Rules for Lump-Sum Sales of Farms and Equipment

Some retiring farmers may not be able to take advantage of installment reporting of the gain on sale of their farm because they do not have the means to finance the buyer's purchase. They would have a greater incentive to sell the farm to a beginning farmer if the tax law allowed them to spread their gain from the sale over the five tax years rather than recognizing all of it in the year of a lump-sum sale. Under this proposal, 20% of the gain from a lump-sum sale of farming assets to a beginning farmer would be reported in each of five years, beginning with the year of the sale. The gain would retain its character as either capital or ordinary gain.

4) Retain Like-kind Exchange Rules under IRC § 1031

Past Congressional rhetoric regarding tax reform explored the elimination of tax deferral using like-kind exchanges. Loss of the ability to defer tax by reinvesting in like-kind property, e.g., real estate, may prevent young farmers from being competitive in the purchase of farm land. If Congress does indeed makes changes to the like-kind exchange rules, transfers of at least some farm real estate could be exempted so that the exiting generation can sell the buildings and some farm land to the entering generation and roll the gain into replacement farmland or other real estate. This would give the entering generation a base upon which to build its own business without the risk that the exiting generation will give or sell the farm to someone else upon death. If necessary for political or other reasons, the provision could be limited to (a) sales under a certain limit such as $1 million; or (b) to family members who must continue farming for a period of time—e.g., 10 years—to avoid triggering recognition of the gain.

5) Enhance Section 529 Plans to Allow Beginning Farmers to Invest in Farms

Under this proposal the tax code would be amended to allow contributions to, and withdrawals from, a 529 account to be invested in farm business capital as an alternative to investing in human capital through higher education. The beneficiaries, envisioned to be young beginning farmer/ranchers as well as young aspiring men and women wanting to continue a family farm or business, can set aside funds in a tax deferred account for the express purpose of purchasing a farm (or business). Withdrawals used for disallowed purposes of the amended 529 account would follow current rules in place. The beneficiary would not receive basis for the amount used in the down payment which came from this proposed account.

Conclusion

Many exiting farm operators want to see the business that they have worked to create be kept together and passed to a new generation of farm operators. Current tax law impacts this transfer by often creating impediments to both parties, and consequently these transfers do not occur. Tax reform could facilitate transfers prior to death of the exiting farmer. Additionally, the proposals which have been outlined here could be used by other closely held, non-farm businesses to facilitate succession and transition to the next generation. Income tax revenues to federal and state coffers would be, in some instances, delayed but still collected over time.

Sources

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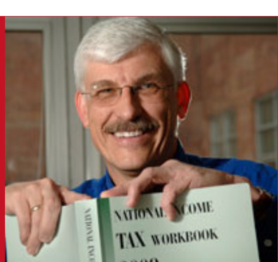

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