Top Five Tax Considerations for Farm Succession Planning in 2023

AUGUST 3, 2023

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#1 - Consider the 2026 Sunset

Estate and Gift Tax

- Estate tax is based upon estate appraisal at fair market value at date of death or six months later.
- Exceptions include:
  - "Special Use Valuation" based on a capitalization rate (up to **$1,230,000 discount in 2022, $1,310,000 in 2023)**
  - Discounts for "minority shareholders"
  - "Qualifying Conservation Easements"
- Each person has their own **unified credit** (for estate and gift tax).
  - The unified credit results in everyone have a standard exemption (basic exclusion amount) from estate and gift tax.

Exemptions Over Time

- 1997 and before = $600,000
- 1998 = $625,000
- 1999 = $650,000
- 2000 and 2001 = $675,000
- 2002 – 2009 = $1.0 million
- 2010 = $ 5 million or opt out with no step up
- 2011= $5.0
- 2012=5.12 million

Exemptions Over Time

- 2016 = $5.45 million
- 2017 = $5.49 million
- 2018 = $11.2 million
- 2019 = $11.4 million
- 2020 = $11.58 million
- 2021=$11.7 million
- 2022=$12.06 million
- **2023=$12.92 million**

Portability

- Unused exclusion amount of spouse dying after 12/31/2010 may be used by surviving spouse
- Only available if election made on timely filed estate tax return (**Form 706**) of predeceased spouse – whether or not estate tax return is otherwise required
- Spouses can **share $24.12 million** in assets in 2022 ($25.84 in 2023) with no estate tax.

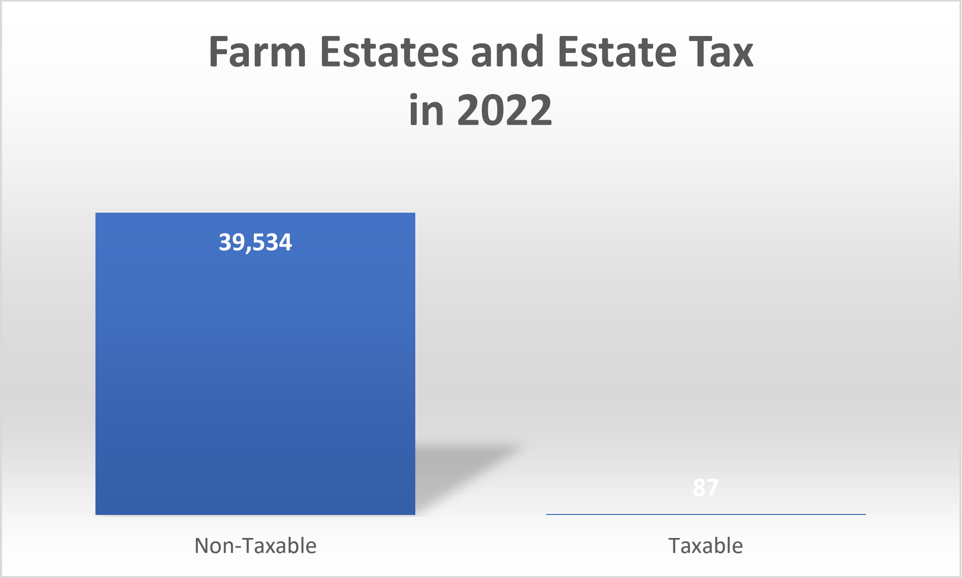
Estate and Gift Tax Rate

- Although estate and gift tax rates are graduated, transfers in excess of the exemption are currently taxed at **40%** because the present exclusion exceeds the top rate threshold of $1 million.

40 Percent

Almost Noone Pays it in 2023

- The USDA-ERS recently estimated that of the projected 39,534 estates created from principal farm operator deaths in 2022, only 305 (0.77 percent) will be required to file an estate tax return, and only 87 (0.22 percent) will likely owe Federal estate tax.



But Higher Exemption is Ending Soon…

- Increased exemption amount was created by the TCJA.
  - It was only temporary.
- **2026=Resets to $5 million, indexed for inflation (~$7 million)**

Generally, No Clawback for Pre-2026 Gifts

- In T.D. 9884 (2019), IRS said there would be no clawback for lifetime gifts made before the exemption declines.
- Existing regulations would also apply DSUE in place at time of first spouse to die.
  - **This makes portability election more, not less, important.**
  - Would (in the absence of contrary future guidance) lock in the higher amount of exclusion for future years, even if exclusion decreases.

Example – Lifetime Gift

- Leeland makes a $12 million lifetime gift in 2023.
- He files Form 709. Leeland dies in 2026, after the exemption has reset to ~$7 million.
- **Under T.D. 9884, Leeland's full gift remains sheltered by the exemption in place in 2023.**

Example – Lifetime Gift

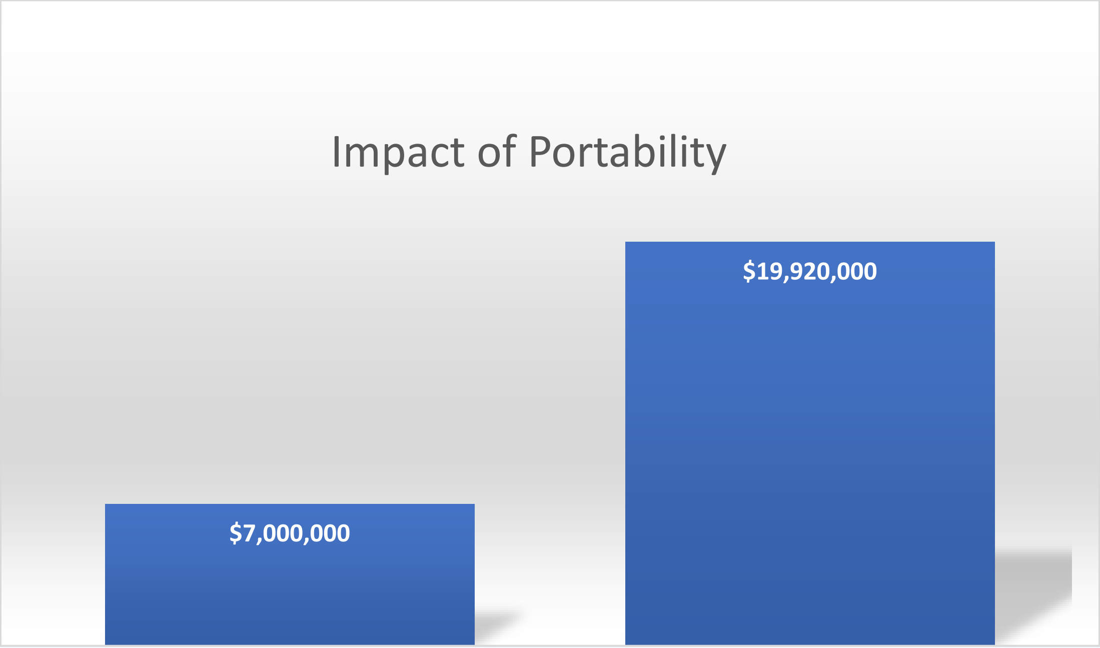
- Laurie gives a $7 million gift in 2023. She files Form 709.
- Laurie dies in 2026 after the exemption resets to ~$7 million.
- Although Laurie could have gifted up to $12.92 million in 2023, she has no exclusion remaining at her death.
- **Any property passed to her heirs at death will be subject to a 40% estate tax**.

Example – Portability

- Lucy dies in 2023, leaving a $12.92 million deceased spouse unused exclusion.
- Lucy's surviving spouse, Syd, elects portability as the executor.
- Syd dies in 2026 after the exemption resets to ~$7 million.
- **Current regulations would allow Lucy's $12.92 million DSUE to apply to Syd's estate**.
- Syd would therefore have **~$19.92 million exemption**.

Example – Portability

- If Syd had not elected portability when Lucy died, Syd would have **only a ~$7 million exemption** at his death. Which exemption would you rather have?



Late Portability Election Extended to Five Years

- **Rev. Proc. 2022-32**
  - Under the new procedure, which supersedes. Rev. Proc. 2017-34, an extension request must be made **on or before the fifth anniversary of the decedent's death.**
  - This simplified method, which doesn't require a user fee, should be used in lieu of the letter ruling process.

#2 - Consider Impact of Income Tax

Basis Planning

- In current environment, for many, income tax **basis planning** has become more important than estate tax planning.
  - Minimize **income** tax since for many no liability for **estate** tax.

- **Basis** = **Cost** minus **depreciation** plus improvements
  - Land is not depreciable

Capital Gains Tax

- Appreciation of farmland means significant capital gain tax liability if sold during lifetime.
- **Capital gain tax = (sales price – basis) * (tax rate)**
  - Preferential Long-Term Rate (generally > one year)
    - **Top rate = 20%.**
  - Short Term Rate = ordinary income tax rate
    - **Top rate = 37% through 2025.**

Sale of Farmland

Randy and Ruby - 1,000 acres of farmland

  - 500 acres in 1974 at a cost basis of $550 / acre.
  - 500 acres in 1987 at a cost basis of $800 / acre.

- If Randy and Ruby sell their farmland in 2023 for $7,200/acre, they will have taxable long-term gain of $6,525 per acre or $6,525,000.
- At current rates, assuming other income is offset by the standard deduction, this sale would result in tax of approximately **$1,267,800** (17.6 percent of the sales price)
  - **Farmers** – No NIIT. No Iowa capital gain.

Sale of Farmland

- This result would change if Randy and Ruby had begun cash renting their land for six years before retiring.
- In that case, the sale would also trigger the **3.8 percent net investment income tax**.
- This would mean an additional $238,450 in NIIT for a total tax bill of **$1,506,250 (21 percent of the sales price).**
- **Likely still no Iowa capital gain tax, but we will discuss soon.**

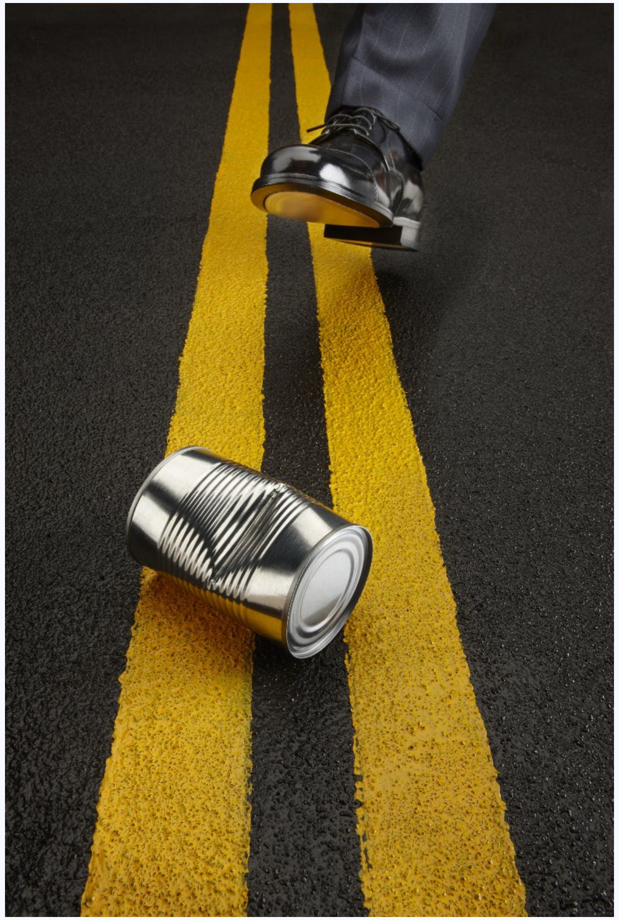
Sale of Personal Residence

- Gain on the sale of a home is excluded from taxation, up to $250,000 per person or $500,000 for married couple.

- Randy and Ruby purchased their home in 2001 for $150,000. It is now worth $350,000.
  - If they sell their house in 2023, the $200,000 in gain would be excluded from taxation.

Other Farm Assets

- The availability of Depreciation, Bonus Depreciation, and Section 179 mean that most farming assets are fully depreciated **before the end of their useful life**.
- While this can assist cash flow during the operation of the business, it is a trap for the unwary when the owner tries to get out.



Sale of Depreciated Assets

- Because of IRC § 1245 and § 1250 recapture, the sale of most farm assets means they will be taxed at ordinary income tax rates, to **recapture** the depreciation that was taken.

- Note: **No self-employment tax** on most recapture.
- **Top rate = 37% through 2025.**

At Retirement, High Tax Liability without Planning

- **Grain in Bin** – Ordinary Income/SE Tax
- **Equipment** – Ordinary income/No SE Tax for recapture
- **Livestock held for sale** – Ordinary Income/SE Tax
- **Dairy/Hog/Poultry Barn** – Ordinary Income/No SE Tax for Recapture
- **Land** – Capital Gain Tax
- **Grain Bins** – Ordinary Income/No SE Tax for recapture
- **Machine Shed** – Ordinary Income/No SE Tax for recapture
- **Feed Inventory** – Ordinary income/SE Tax

Farm Sale Example

Tax Character of Assets from 400-Acre Crop and Livestock Farm

Asset	FMV	Basis	Gain	Character
Raised Dairy and Breeding (at least 24 months)	$75,000	0	$75,000	1231 Gain
Farmland	$4,800,000	$800,000	$4,000,000	1231 Gain
Purchased Dairy and Breeding	$200,000	$50,000	$150,000	1245 Gain
Machinery	$600,000	$150,000	$450,000	1245 Gain
Poultry, Hog or Dairy Barn	$250,000	0	$250,000	1245 Gain
Bins	$75,000	0	$75,000	1245 Gain
Multi-Purpose Building	$500,000	$100,000	$400,000	1250 Gain
Personal Residence	$300,000	$100,000	$200,000	Excluded
Raised Dairy and Breeding (< 24 months)	$30,000	0	$30,000	Ordinary
Feed Inventory	$50,000	0	$50,000	Ordinary, SE Tax
Stored Grain	500,000	0	500,000	Ordinary/SE Tax
Supplies and Fuel	$40,000	0	$40,000	Ordinary/SE Tax
Livestock Held for Sale	$150,000	0	$150,000	Ordinary/SE Tax
			$6,370,000	

A sale would result in $6,370,000 of taxable gain, generating a federal tax bill of around $1.5 million.

If not selling land, tax liability would still be around $500,000.

Options - Die

- Under current law, property transferred at death receives a **basis adjustment** in the hands of the recipient.
- Generally, the basis in the hands of the recipient will equal the fair market value (FMV) of the property at the date of death or six months thereafter.

What Happens at Death?

Tax Character of Same Assets after Owner Dies

Asset	FMV	Basis	Gain	Character
Raised Dairy and Breeding (at least 24 months)	$75,000	$75,000	0	1231 Gain
Farmland	$4,800,000	$4,800,000	0	1231 Gain
Purchased Dairy and Breeding	$200,000	$200,000	0	1245 Gain
Machinery	$600,000	$600,000	0	1245 Gain
Poultry, Hog or Dairy Barn	$250,000	$250,000	0	1245 Gain
Bins	$75,000	$75,000	0	1245 Gain
Multi-Purpose Building	$500,000	$500,000	0	1250 Gain
Personal Residence	$300,000	$300,000	0	
Raised Dairy and Breeding (< 24 months)	$30,000	$30,000	0	Ordinary
Feed Inventory	$50,000	$50,000	0	Ordinary, SE Tax
Stored Grain	$500,000	$500,000	0	Ordinary/SE Tax
Supplies and Fuel	$40,000	$40,000	0	Ordinary/SE Tax
Livestock Held for Sale	$150,000	$150,000	0	Ordinary/SE Tax
			0	

A sale would result in NO TAXABLE GAIN

Options While Alive - Gift

- Property transferred through a lifetime gift is treated differently for tax purposes. The gift does not trigger income tax liability, but the recipient of the gift takes the property with the donor’s basis.
- This means that while gain is not realized when the gift is made, it is not eliminated. If the recipient sells the property, tax will be recognized on the gain, or the difference between the basis and the sales price.
- The recipient **will not receive a new basis to depreciate**.
- Removes property from donor’s estate.

Options While Alive – Gift

Asset	FMV	Basis	Gain
Raised Dairy and Breeding (at least 24 months)	$75,000	0	$75,000
Farmland	$4,800,000	$800,000	$4,000,000
Purchased Dairy and Breeding	$200,000	$50,000	$150,000
Machinery	$600,000	$150,000	$450,000
Poultry, Hog or Dairy Barn	$250,000	0	$250,000
Bins	$75,000	0	$75,000
Multi-Purpose Building	$500,000	$100,000	$400,000
Personal Residence	$300,000	$100,000	$200,000
Raised Dairy and Breeding (< 24 months)	$30,000	0	$30,000
Feed Inventory	$50,000	0	$50,000
Stored Grain	500,000	0	500,000
Supplies and Fuel	$40,000	0	$40,000
Livestock Held for Sale	$150,000	0	$150,000
			$6,370,000

A sale would result in TAXABLE GAIN. Recipient of gift would NOT be able to depreciation assets.

Tax Friendly Transfer Options During Life

- Installment Sale
- Rental Agreements
- Like-Kind Exchanges
- Some Business Entity Transfers

3 – Consider the Dangers of False Promises

Abusive Tax Schemes IRS is Targeting

- Each year, IRS warns taxpayer and professionals of common trends of abusive tax schemes that promoters are pushing on unwary taxpayers.
- **Ag producers are particularly susceptible to several of these schemes.**
- Where appropriate, the IRS will challenge the purported tax benefits from the transactions on this list, and the **IRS may assert accuracy-related penalties ranging from 20% to 40%, or a civil fraud penalty of 75% of any underpayment of tax**.

Beware of Scams

- In exchange for LARGE FEES, promoters have been twisting legitimate tax rules and promising farmers and landowners benefits that do not exist, placing them in legal jeopardy.
- The IRS has placed charitable remainder annuity trusts (CRATs) and monetized installment agreements on their Dirty Dozen list of tax scams. The IRS has characterized the Dirty Dozen as the “worst of the worst” tax schemes being promoted to unwary taxpayers.
  - Ag producers and landowners are the targets. Again, these scams take legitimate tax rules and twist them. Seek trusted counsel before paying a third-party to save you tax!!

Charitable Remainder Trust Scam

- *Furrer v. Comm'r, T.C. Memo 2022-11 (Sept. 28, 2022)*
- Example of a scheme promoters have been peddling with farmers:
  - An Indiana farm couple was encouraged to transfer into a CRAT 100,000 bushels of corn and 10,000 bushels of soybeans grown on their farm. The CRAT then sold the crops for $469,003 and made annual annuity payments of $84,368 to petitioners in 2015–2017.
  - In 2016, the farmers created a second CRAT and transferred into it 11,335 bushels of corn and 31,064 bushels of soybeans. The second CRAT sold the crops for $691,827 and again invested in a SPIA. The trust paid $124,921 to the farmers in 2016 and 2017.

Charitable Remainder Trust Scam

- On their tax returns for the three audited years, the taxpayers **did not report the annuity payments as income.** Instead, they argued that the payments constituted a nontaxable return of corpus.
- The IRS examined the returns for the three tax years at issue and increased the taxpayers' Schedule F farm income by $83,440 in 2015 and by $206,967 in 2016 and 2017.

Example - Charitable Remainder Trust

- In 2022, Rodney retired from farming. He had **$1 million** in fully depreciated machinery and grain on hand that he wanted to sell. If he sold the property outright, however, he would have paid more than **$400,000 in tax, leaving $600,000 to invest for retirement**. Rodney was also charitable minded, and wanted to donate to his favorite charity.
- After meeting with his advisors, Rodney decided to contribute the machinery and grain to a CRAT. He received no charitable deduction for this contribution (because the basis of the property was zero), but the CRAT sold the assets without paying any tax. The CRAT then invested the **$1 million proceeds in diversified funds**.

Charitable Remainder Trust - Example

- Rodney, who was 65 years old, chose a 15-year term, with a distribution percentage of 7.84%. His terms are shown here:

Amount Transferred to CRT	$1,000,000
Annuity Trust Payout (AFR Aug 2022 = 3.8%)	$78,400 / year for 15 years
Present Value of Annuity	$899,292
Present Value Remainder	$100,708

Charitable Remainder Trust - Example

- If Rodney passes away **before the 15 years is up, his heirs will receive the income stream.**
- Rodney will receive a fixed income of $78,400 for 15 years, and the charity will receive a projected $100,708 when the trust terminates.
- Because Rodney's payments are level, he is able to keep his income in a lower bracket.
- **Rodney will pay ordinary income tax on the payments, but they will not be subject to self-employment tax (this is where the scams go off the rails).**

#4 - Consider Iowa’s New Tax Laws

New Iowa Tax Law - 2023

- On **March 1, 2022**, Governor Kim Reynolds signed **H.F. 2317** into law. The new tax law reduces individual and corporate income tax rates, provides exemptions from Iowa tax for certain forms of retirement income--including retired farmer rental income--and scales back certain tax credits.
- These changes have different effective dates, but **most changes have begun phasing in during the 2023 tax year**.
  - Generally, this new law will impact tax returns filed in 2024, but some decisions may need to be made now

RETIREMENT INCOME EXCLUSION

Retirement Income Exclusion

- **Beginning in 2023**, Division VI of the new law modifies Iowa Code § 422.5(3)(a) to exempt from Iowa taxation **all "retirement income"** for those who are:
  - ***Disabled*** or
  - ***55 years of age or older***

“Retirement Income”

- Includes distributions from:
  - IRAs authorized under IRC § 408;
  - Simplified Employee Pension (SEP) plans;
  - SIMPLE retirement plan;
  - Keogh plans;
  - Qualified pension plans, including IPERS;
  - Roth conversion income;
  - Qualified deferred compensation plans governed by ERISA including a 401(k), 403(b), and 457(b) plan;
  - Annuity plans covered by IRC section 402(a);
  - Employee Stock Ownership Plans (ESOP) as defined in section 4975(e)(7) of the IRC

The Retired Farmer Rule

- For many farmers, Farm Rental Income = retirement income.

Retired Farmer Lease Income Exclusion

- The new law amends Iowa Code § 422.7 by adding a new subsection to **allow some "eligible individuals" to <u>elect to exclude from Iowa income:</u>**
  - the net income received from a "**farm tenancy agreement**"
  - covering real property held by the "**eligible individual**" for 10 or more years
  - if the eligible individual **materially participated** in a "**farming business**" for 10 or more years.

Retired Farmer – "Eligible Individual"

- An individual who is:
  - **Disabled** or **55 years of age or older** at the time the election is made
  - Who **no longer materially participates in a farming business** at the time the election is made, and
  - Who, as **an owner-lessor**, is **a party to a "farm tenancy agreement"**

Farm Tenancy Agreement

- A **WRITTEN agreement** outlining the rights and obligations of an owner-lessor and a tenant-lessee where the tenant-lessee has a farm tenancy as defined in **Iowa Code § 562.1A**:
  - **A leasehold interest in land** held by a person who produces crops or provides for the care and feeding of livestock on the land, including by grazing or supplying feed to the livestock.

Farm Tenancy Agreement

- A “farm tenancy agreement” includes **cash leases, crop share leases, or livestock share leases.**
- **But remember, it must be in writing.**

Restrictions: Income Passed Through from Entities

- Net income from a farm tenancy agreement earned, received, or reported by an entity **taxed as a partnership for federal tax purposes**, an **S corporation**, or a **trust or estate** <u>is not eligible</u> for the election and deduction in this subsection, even if such net income ultimately passes through to an eligible individual.
  - **Must wait for regulations to know how IDOR will treat disregarded entities like SMLLCs and RLTs.**

Other Restrictions for Lease Income Exclusion

- Individuals who make an election under this section **may not**:
  - Apply the Iowa Capital Gain Deduction to proceeds from the sale property **in the current <u>or succeeding tax years</u>**
  - Take the Beginning Farmer Tax Credit **in the current <u>or succeeding tax years</u>**

Retired Farmer Lease Income Exclusion Summary

- ✓It's an **election**
- ✓Must be an **individual**
- ✓Must be **disabled** or **55 years old** or older
- ✓Must **no longer materially participate** in a farming business
- ✓Must **have materially participated** in a farming business for 10 years or more
- ✓Must **have held the property** covered by the farm tenancy agreement for 10 years or more
- ✓Must by a **party to the farm tenancy agreement** as an **owner-lessor**
- ✓The agreement **must be in writing**
- ✓Must not have made an election for a **single lifetime exemption** to exclude capital gain from Iowa income
- ✓Will not be eligible for the **Beginning Farmer Tax Credit** or the **Iowa Capital Gain Deduction** in future years

CAPITAL GAIN DEDUCTION MODIFICATIONS

Iowa Capital Gain Deduction – 2023

- Applies only to the sale of **real property used in a farming business** if:
  - The taxpayer has materially participated in a farming business for a minimum of 10 years and has held the real property used in a farming business for a minimum of 10 years. **If the taxpayer is a retired farmer, the taxpayer is considered to meet the material participation requirement if the taxpayer materially participated in a farming business for 10 years or more in the aggregate, prior to making an election under this subsection.**

    OR
  - The taxpayer has held the **real property used in a farming business** which is sold to a relative of the taxpayer (holding period and material participation do not matter).

Retired Farmer

- An individual who is disabled or who is 55 years of age or older and who **no longer materially participates** in a farming business when an exclusion and deduction is claimed under this subsection.

Relative (Three Ways to Qualify)

A. The individual is related to the taxpayer by consanguinity or affinity within the second degree as determined by common law.
   - **Wait for rules to be certain:** Brother, sister, grandparent, grandchild, daughter-in-law, son-in-law, parent-in-law?

B. The individual is a lineal descendent of the taxpayer.
   - Children of the taxpayer, including legally adopted children and biological children, stepchildren, grandchildren, great-grandchildren, and any other lineal descendent of the taxpayer.

C. An entity in which an individual who satisfies the conditions of either A or B has a legal or equitable interest as an **owner, member, partner, or beneficiary**.
   - No percentage requirement.

Iowa Capital Gain Deduction – Retired or Disabled Farmers

- The law also allows retired or disabled farmers to deduct gain from the sale of breeding, draft, dairy or sport cattle or horses (held for 24 months or more) if the taxpayer:
  - **Materially participated in the farming business for <u>five of the eight years preceding</u> retirement or disability**, and
  - **Sold <u>all or substantially all</u> of the taxpayer's <u>interest in the farming business</u> when the election is made**.

- The same rule applies to the sale of other breeding livestock held for a period of 12 months or more.

Iowa Capital Gain Deduction

- **Retired farmers** may make a **single lifetime election** to exclude **all qualifying capital gains** under these provisions.
- However, retired farmers who elect to exclude gain under this provision:
  - ✓ May not claim the beginning farmer tax credit in the current or any subsequent tax year.
  - ✓ May not make an election to exclude net income received from a written farm tenancy agreement in the current or any subsequent tax year.
- **May not make this election if the retired farmer has made an election to exclude rental income.**

Mutually Exclusive Election

Retired Farmers must decide

Farm Tenancy Income Exclusion

OR

Iowa Capital Gain Deduction

#5 – Seek Excellent Advice

Engage Excellent Counsel

- Make sure you find experienced, qualified legal and tax counsel to help establish and maintain the ongoing viability of any business structures.
  - Lots of pitfalls and risks when rules are not understood or followed.
- This is not the place to cut corners.
- Legal Zoom will NOT meet your needs.
- Do not seek counsel from inexperienced attorneys, tax advisors, or insurance or retirement specialists.
  - They must understand farm operations.

- The cost of mistakes far exceeds cost of good advice.

NEW RESOURCE

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