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INCOME TAX MYTHS, TRUTHS, AND EXAMPLES CONCERNING FARM PROPERTY DISPOSITIONS

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INCOME TAX MYTHS, TRUTHS, AND EXAMPLES CONCERNING FARM PROPERTY DISPOSITIONS

Introduction

Each year many farm families sell or dispose of some of their farm business assets. Typical sales vary from crops that had been inventoried to dairy cows and breeding livestock. The sales of all livestock, machinery, land, and buildings by farm families are not a common annual occurrence. Most farmers are not fully aware of the income tax consequences of major sales. Many are shocked by the magnitude of their income tax bills after they have sold the farm and some do not have the resources to pay them. Sales or dispositions resulting from low profitability, negative returns, and the inability to make payments are extremely difficult for farmers to manage. Additional financial burdens such as income taxes compound the decision making process and add to family stress.

Farm families need to be well informed of the income tax consequences of property dispositions so the shock and stress caused by unexpected tax bills can be avoided. Following are some basic income tax myths, truths, and examples that will enable the farm owner to be better informed of many of the most important income tax management opportunities and rules affecting farm property sales.

Know Your Tax Basis and How To Use It

Myth #1: When farm property is sold, taxable gain is the difference between the sale price and the unrecovered cost of the property recorded in the depreciation schedule

Truth: The taxable gain is the difference between the sales price (less selling expenses) and the income tax BASIS of the property sold. The BASIS includes, but is not limited to, the unrecovered cost of depreciable property. Knowing and understanding how to determine the basis of property is fundamental to tax planning. BASIS is valuable. The higher the basis, the lower the taxable gain. A record of the cost and basis of all property acquired is needed to determine BASIS when the property is sold.

Rules: BASIS of property you bought = cost less depreciation
BASIS of property you raised = zero
BASIS of property you inherited = appraised value in estate
BASIS of property gifted to you = basis in hands of donor

Example: Don Detail sells his raised cows, crops, purchased machinery, and farm real estate for $750,000. The sale includes: 50 acres of land given to him by his father, the main farm he purchased from his mother, a farm house he inherited from his mother, additional farmland he purchased, and a new barn he constructed. The cost of the sale was $35,000. The basis and taxable gain on each item are reported on the following page.

Basis and Taxable Gain from Sale

Item	Sale Price	Cost of Sale	Basis	Taxable Gain
Raised crops	$ 40,000	$ 2,000	$ 0	$ 38,000
Raised cows	160,000	8,000	0	152,000
Machinery	150,000	7,000	63,000	80,000
50 acre gift	45,000	2,000	13,000	30,000
Main farm	150,000	7,000	78,000	65,000
Farm house	80,000	4,000	51,000	25,000
Purchased land	55,000	2,000	33,000	20,000
New barn	70,000	3,000	37,000	30,000
Total	$750,000	$35,000	$275,000	$440,000

Excluding gain from his house, Don has $148,000 of ordinary income (crops, machinery, and new barn) and $267,000 of capital gain income (raised dairy cows, 50 acres, main farm, and purchased land) from the sale of the farm. Federal and New York State income taxes may exceed $147,000 or 35 percent of taxable gain recognized from the sale. Actual taxes on the sale will depend not only on sale income but the amount of other income in the year of sale.

Don has excellent records on all property acquired which enables him to determine an accurate basis. All cattle and crops were raised. They have a zero basis because the costs of growing and raising are deducted on Schedule F. The $63,000 unrecovered cost or basis for machinery is found on Don's depreciation schedule.

When Don received the gift of land from his father, he recorded its current market value, the $10,000 price Dad paid for the land in 1954, and $1,200 for non-depreciable land improvements made in 1960. Dad's basis was $11,200 and that became Don's basis when the gift was made. Don's records show he spent $1,800 on hedgerow removal (not expensed) since owning the property. His basis on the 50 acres of land is now $13,000.

The main farm was purchased for $100,000, $50,000 was allocated to land and $50,000 to depreciable buildings. The $78,000 of basis includes $50,000 initial basis of land plus $5,000 of undepreciated land improvements and $23,000 of undepreciated building improvements. The original $50,000 allocated to buildings is fully depreciated (straight line).

The farm house (Don's residence) was appraised at $40,000 in Don's mother's estate and that became Don's initial basis. He has added $11,000 of capital improvements making the current basis $51,000. Additional land was bought for $30,000 and tile drainage was installed. The unrecovered cost of the drainage project is $3,000 giving Don a basis of $33,000 on the additional land. The new barn cost $130,000 but $93,000 has been recovered through depreciation leaving a basis of $37,000.

Note that only $126,000 of Don's basis comes from his tax depreciation schedule. The remaining $149,000 of basis is found in Don's "Detail" record of real estate purchases, acquisitions, and capital improvements.

Opportunities: The opportunity to maximize basis and minimize taxable gain by keeping accurate and continuous records of capital expenses is illustrated in the preceding example.

Other tax management opportunities for Don Detail include:

a. Allocate a greater proportion of the sale to the farm house since it is Don's residence and roll it over into a new home or use Don's lifetime exemption.

b. Allocate more to land and the main farm and less to cattle, crops, and machinery to take advantage of the maximum 28 percent tax on capital gains.

c. Spread the sale out over two or more tax years.

d. Consider a sale contract for some or all of the real property.

Precautions:

- Price allocations should not be changed after the sales agreement has been accepted and signed by the buyer unless all parties are in agreement.

- There will be ordinary income from the recapture of depreciation on machinery, equipment, single purpose livestock structures, and certain conservation expenditures.

- Although there will be no recapture for federal investment credit on dispositions after 1990, the potential recapture of New York State investment credit continues to be an important consequence.

- Farm filing privileges may be lost when major sales of farm property occur (see Myth #8).

A Major Income Tax Exclusion

Myth #2: There is a major tax exclusion that applies to the sale of all farm land and buildings.

Truth: There is a $125,000 exclusion on the sale of a taxpayer's principal residence that farmers and all other qualified taxpayers may use once in their lifetime. There are no other major tax exclusions on the sale of farm real estate although there are opportunities to save taxes through trades or tax free exchanges (see page 7).

Rules: Once in your lifetime you may exclude up to $125,000 of any gain realized on the sale of your principal residence from your gross income if:

- You are age 55 or over on the date the residence is sold or your spouse is 55 or over and she or he is joint owner of the residence.
- You file a joint return if married. Your exclusion is $62,500 if you are married and file a separate return. Single taxpayers generally qualify for the $125,000 exclusion.
- You owned the home and it was your principal residence for at least three out of the last five years.
- You make the election to take the exclusion on Form 2119 filed for the year of the sale or you may make it by filing an amended return within three years. You also may revoke the election within three years of the sale.
- You may use the rollover or non-recognition-of-gain provision in addition to the $125,000 exclusion.

Example: Frank and Fran Furrow plan to sell their 250 acre crop farm including their personal residence for $360,000 and move into a lifetime retirement center. Frank is 69 years old, files a joint return with Fran, and qualifies for the $125,000 lifetime exemption on the personal residence. The tentative sale agreement has the Furrow land at $250,000, farm buildings $25,000, and farm house $85,000. The basis of their house is $10,000. Frank and Fran may claim the $75,000 exclusion on the gain from the sale of their home. The farmland and buildings have a basis of $80,000 so there will be a taxable gain of $195,000.

Opportunity: The Furrows can reduce the taxable gain on the sale of their farm by $50,000 if they allocate $135,000 to their residence and $200,000 to the land. This is a potential federal and New York State income tax saving of approximately $18,000 for the Furrows.

How Debt Affects Taxable Gain

Myth #3: When mortgaged or secured farm property is sold and the proceeds are used to pay off debt, taxable gain is calculated net of principal paid off.

Truth: Taxable gain is not reduced by mortgage and most other debt payments. Taxable gain is the difference between the sale price (less sale expenses) and the basis of property sold.

Example: Henry and Hilda Hardluck sell livestock, machinery, and farm real estate on a depressed market for $620,000. Prior to the sale the Hardluck farm property was valued at $750,000 with debt of $500,000 and a basis of $200,000. The personal residence is not included in the sale. Sale expenses are $20,000. The gain on the sale is ($620,000 - $20,000 - $200,000) = $400,000. The net sale proceeds after debt payments are only ($620,000 - $20,000 - $500,000) = $100,000. The

tentative federal and New York State income tax is $140,000, $40,000 greater than the net proceeds from the sale.

Opportunities: The Hardluck farm business debt/asset ratio was very high (0.67) before the sale. This is an indication that the farm has not been profitable in recent years. Look for net operating losses and unused investment tax credit that can be carried forward to reduce the $140,000 tax liability. If the tax liability is greater than available funds, work out a payment schedule with IRS before late penalties and interest are assessed.

Precaution: Initially, discharge of debt is treated the same as money received in calculating taxable gain. If the Hardlucks sold for $520,000 and the Hardland bank canceled $100,000 of their mortgage, their tentative taxable gain would have been $520,000 - $20,000 - $200,000 + $100,000) = $400,000.

However, the Hardlucks were insolvent before the discharge of debt and they can exclude discharge of indebtedness income that does not exceed the amount of their insolvency. If they had been solvent before or immediately after the discharge, they may qualify for additional relief under the solvent farmer rules.

Reporting Receipts of Sales Proceeds

Myth #4: I can reduce or postpone the taxes on the sale of my farm by placing the proceeds in trust, escrow or non-taxable investments.

Truth: Once the farm is sold and the proceeds are constructively received (the money is credited to your account or available to you without restriction), you have received the sale proceeds for income tax purposes.

Example: Red and Rita Retiree sell $200,000 of farm real estate to son Randy. The property has a tax basis of $80,000. Randy pays $50,000 down and borrows $150,000 from Hometown Bank. Red and Rita direct the bank to put the $150,000 into an escrow account that they plan to use to purchase an annuity for their retirement. Red and Rita have a taxable gain of $120,000, ($200,000 - $80,000), to report in the year of sale. The $150,000 put in escrow was available or constructively received when the real estate was sold.

Opportunities:

1. Red and Rita may have elected to finance the sale for Randy by holding his personal note or mortgage for $150,000. The sale would qualify under the installment method of reporting and each principal payment would be reported in the year it was received.

2. Red and Rita may have been able to invest the $200,000 in like property that would qualify as a tax free exchange (see Tax Free Trades on page 8).

Family Sales Agreements

Myth #5: If I sell the farm to my son/daughter we can determine our own sale price and repayment plan.

Truth: You can establish your own sale price providing it represents reasonable current market or agricultural use valuation. If your sale price is substantially below market value, IRS may consider the difference a gift made by the seller. You can establish your own payment schedule but the interest rate must meet IRS regulations.

Rules:

1. The sale of land between family members must have a stated interest rate of at least six percent or IRS will impute a seven percent rate. This rule applies to the first $500,000 of land sold between related people in one calendar year.

2. All other installment sales where seller financing does not exceed $2.8 million must have a minimum interest rate of nine percent or 100 percent of the Applicable Federal Rate.

Example: Assume Red and Rita elect to finance $150,000 of the farm real estate sale to Randy. The $200,000 sales price includes $50,000 for buildings and $150,000 for land. The $50,000 down payment is specified for buildings, so the $150,000 installment contract is for land and qualifies for six percent interest. They decide on a 10 year repayment period so the payments will be $1,665 per month.

Opportunity: Applicable Federal Rates (AFR) for short and mid-term loans are currently running below eight percent interest. Check the current and prior month's AFR before completing the terms of an installment contract.

Tax Implications and Opportunities of Gifting Property

Myth #6: If I make gifts of farm property to my children, I am merely substituting one tax problem for another.

Truth: You can make substantial gifts without incurring any gift tax liability during your lifetime or for your estate. The value of a gift is not taxable income to the one who receives it.

Rules:

1. Every individual has an annual gift tax exemption of $10,000 per donee. Together you and your spouse have an annual gift exemption of $20,000 per donee.

2. Every individual has a unified federal gift and estate tax credit of $192,800 that is equivalent to a $600,000 exemption. You can use the unified credit during your lifetime and/or to settle your estate.

3. The unified credit is in addition to the annual gift tax exemption.

4. When property is gifted, the donor's tax basis of the property is transferred to the donee.

Example:

Gene and Gerry Generous decide to use a combination of sale and gifts to transfer the ownership of their fruit business to daughter and son-in-law Fay and Frank Fortunate. They sell the original orchard and the packing and storage buildings for $600,000. They gift fruit block H valued at $50,000 to Fay and Frank. They rent to Fay and Frank six additional blocks valued at $50,000 each with plans to sell or gift them in the future.

Together Gene and Gerry may give Fay and Frank $40,000 each year under their annual $10,000 exemption. Since they made a generous $50,000 gift in one year and exceeded their annual exemption by $10,000, they must file a gift tax return which IRS will keep to show that Gene and Gerry have used up $10,000 of their lifetime exemption. If they continue to transfer the ownership of fruit blocks through annual gifts of $50,000 or more they must continue to file annual gift tax returns. The amounts exceeding the annual gift exclusion will be accumulated to offset the $600,000 unified gift and estate tax exemption.

Opportunities:

1. To minimize income taxes from their $600,000 sale, Gene and Gerry should include property with the highest basis. They have included the new apple storage that has a basis of $200,000. They value it at $200,000 and avoid all taxable gain on the sale of the storage.

2. To help Fay and Frank minimize income taxes on future income and property sales, Gene and Gerry should gift property with a high basis. Fruit block H has been in production for only one year and has a basis of $25,000. The fruit trees have a basis of $20,000 and may be depreciated by Fay and Frank.

Precaution:

New York State recognizes the $10,000 annual gift exemption but not the $600,000 lifetime exemption. The New York State estate and gift tax is imposed on cumulative transfers of $108,334 or more.

Tax Free Trades

Myth #7: Tax free trades are limited to machinery and equipment.

Truth: Any property, including real estate held for business use or investment, may be exchanged for like property resulting in no taxable gain if arranged and managed correctly.

Rules:

1. The property exchanged (given up and received) must be business or investment property.

2. Property held for sale does not qualify.

3. The property exchanged must be "like" property. This means machinery and equipment for machinery and equipment, and business real estate for business or investment real estate. For example, farm real estate may be exchanged for business real estate in town or for undeveloped real estate in another state.

4. The property to be received must be identified within 45 days after the transfer of property given up and the entire transfer must be completed in 180 days or by the due date for the return of the year the property was given up.

5. Money from the first part for the transfer may be escrowed to secure the completion of the transfer without it being treated as a constructive receipt. Make sure this escrow account is properly handled. Seek advice from competent tax advisors.

6. If a third party arranges and manages the transfer it must be a qualified, independent tax free exchange facilitator, and cannot be the property owner's attorney or real estate broker.

Example: A.B. Alternative decides to discontinue crop farming to become the owner-manager of an apartment building in town. His crop farm real estate is valued at $360,000 excluding his personal residence and has a tax basis of $100,000. The apartment building is available for $320,000. A.B.'s attorney obtains the services of a firm qualified in arranging tax free exchanges. They find a buyer for A.B.'s farm and put $320,000 from the transfer in escrow on February 1st to be used to acquire the apartment building. A.B. can not receive the money that is in escrow unless the apartment building or a suitable substitute cannot be acquired in 180 days. The exchange is completed in 90 days and the $320,000 escrow is used to acquire the apartment building and pay the associated fees.

A.B. Alternative has a $320,000 tax free exchange plus $40,000 gain from the sale of his farm.

The Estimated Tax Trap

Myth #8: As long as I do not receive off-farm income, I can continue to use farm taxpayer filing rules and avoid quarterly estimates.

Truth: You can continue to file your return on March 1st and avoid quarterly estimates if at least two-thirds of your total gross income was from farming during this or for the last taxable year.

Rules:

1. Total gross income includes your spouse's income if you file a joint return, interest income, taxable gains from the sale of all business and investment property as well as gross income from farming.

2. Gross income from farming includes total farm income (receipts) from Part I, Schedule F; farm rental income from Form 4835, gross farm income from Schedule E, and gains from the sale of livestock held for breeding, dairy, draft or sporting purposes.

Example: Albert D. Dairyfarmer sold his dairy cattle last year and has sold much of his farm machinery this year. He plans to sell some farm real estate next year. Last year Mr. and Mrs. A.D. had a joint total gross income of $190,000 which included: $30,000 Mrs. A.D.'s salary, $5,000 interest and dividend income, $60,000 total farm income from Schedule F, and $95,000 from the sale of dairy cattle. Gross income from farming was $155,000 ($60,000 + $95,000) or 82 percent of total gross income. Mr. and Mrs. A.D. qualified to use the farm taxpayer filing rules last year and that qualification covers them for this year.

This year their estimated adjusted gross income is $130,000; $32,000 Mrs. A.D.'s salary, $8,000 interest and dividends, $10,000 from Schedule F, and $80,000 gain from machinery sales. Adjusted gross income from farming is only $10,000, less than 10 percent of total gross income. The A.D.'s no longer qualify as farm taxpayers. Next year they must follow the estimated payment and quarterly filing rules required of non-farm taxpayers.

<u>Other Agricultural Economics Extension Publications</u>

No.	Title	Author(s)
No. 91-18	Supermarket Dairy Department: An Overview of Operations and Performance	Edward McLaughlin David Russo
No. 91-19	Dairy Farm Business Summary Eastern New York Renter Summary 1990	Linda D. Putnam Stuart F. Smith
No. 91-20	National and State Trends in Milk Production, 1991	Andrew Novakovic Kevin Jack Maura Keniston
No. 91-21	New York Milk Production from 1979 to 1989: A County and Regional Analysis	Kevin E. Jack Andrew M. Novakovic
No. 91-22	Fruit Farm Business Summary Lake Ontario Region New York 1990	Darwin P. Snyder Alison M. DeMarree
No. 91-23	Time-of-Use Pricing for Electric Power: Implications for New York Dairy Farmers	Mark C. Middagh Nelson L. Bills Richard N. Boisvert
No. 91-24	Custom Raising Dairy Replacements: Practices and Costs, 1990	Jason A. Karszes B. F. Stanton
No. 91-25	The Year 2000: A Food Industry Forecast	David M. Russo Edward W. McLaughlin
No. 91-26	List of Available Agricultural Economics Publications July 1, 1990 - June 30, 1991	Dolores Walker
No. 91-27	Pro-Dairy Financial Data Collection Workbook	Jonas B. Kaufman Stuart F. Smith Linda D. Putnam