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White paper

Pros and cons to transition planning today

Gifting and tax consideration for farm assets

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Current environment of agriculture

Farm transition planning is challenging. It is an emotional topic to discuss and can change the dynamics of a family if not all parties agree with the direction that will be taken for the future of the farm. On top of those challenges, there are financial and tax considerations that can greatly impact how the farm is transitioned. This can make for an already complex situation seem like a mountain that is too steep to climb.

However, given the current environment that COVID-19 has created, this may be a good opportunity for farmers to consider doing some transition planning. For many farmers, COVID-19 has not only affected the manner in which they farm but also the value of their commodities and the overall value of their operation. In this article we will discuss the pros and cons of gifting farm related assets today, how these decisions will impact your income taxation planning, and who should be involved in these discussions.

Gifting your farm assets

Gifting farm related assets can be an extremely generous way of transition planning. However, the decision to make gifts during life could come with some disadvantages associated with that gift from an income tax planning perspective. These advantages and disadvantages will depend on what the recipient of that property does with that gifted asset. Capital gains tax and income recapture could be triggered as a result of the sale of a gifted asset. These tax implications can make a farmer feel as though they should keep their assets until death as opposed to gifting assets during life if the next generation is likely to sell that asset.

Under current tax law, it can be very advantageous to hold onto assets, specifically farm land, until the owner of those assets has passed away. Retaining assets until death allows for a step-up in basis in those assets. This step-up in basis places the basis in the asset at fair market value at the time of death. A party receiving gifted assets during life will not receive a step-up in basis. The cost basis in assets that are gifted during life carries over to the new party. For some assets, this could mean an extremely low-cost basis with a much higher fair market value leading to large capital gains if sold by the recipient of that gifted asset. If the gift is made to the receiving party after the death of the owner, the basis in that asset is now the fair market value of that asset based on when the executor valued that asset. This step-up in basis allows the receiving party to now sell that asset potentially free from capital gains tax (assuming no gain from the time of the receipt to the time of the sale).

For those farmers with large estates, federal estate taxes bring another wrinkle into transition planning. If a farmer currently has an estate over $11.58 million in 2020 ($22.8 million for married couples) it may be worth considering gifting some assets while they have a depressed value to remove them from the farmers estate. This gift of assets today will allow the growth of the asset to occur in that recipient's estate as opposed to being part of the owner's estate. This could save the farmer's family significant federal estate taxes as the current top federal estate tax rate is 40%.

Capital gains tax planning

For most farmers with estates under $11.58 million ($22.8 million for married couples), gifting can still be good to consider. While the loss of the step-up in basis generally makes gifting during life less favorable, it can still serve a purpose from an income tax planning perspective. Gifting assets can be a good strategy to shift capital gains taxation to family members that have lower tax rates. For example, if a family member is earning under $40,000 annually, that individual would pay no capital gains tax if they were single and held onto the gifted asset for at least one year prior to the sale of the asset.

Long-term capital gains tax applies to assets that have been held/owned for more than one year. Long-term capital gains tax rates start at 15% for individuals with earnings more than $40,000 annually. If a farmer sells gifted property this tax can be a substantial amount owed. For example, a farmer receives a farm asset with a basis of $50,000 and a current fair market value of $300,000. If sold, the farmer would have $250,000 of capital gains on the property. This sale would result in a capital gains tax bill of $37,500 ($250,000 X 15%). As earnings increase so do capital gains tax rates. For individuals earning over $441,450 that rate is 20%.

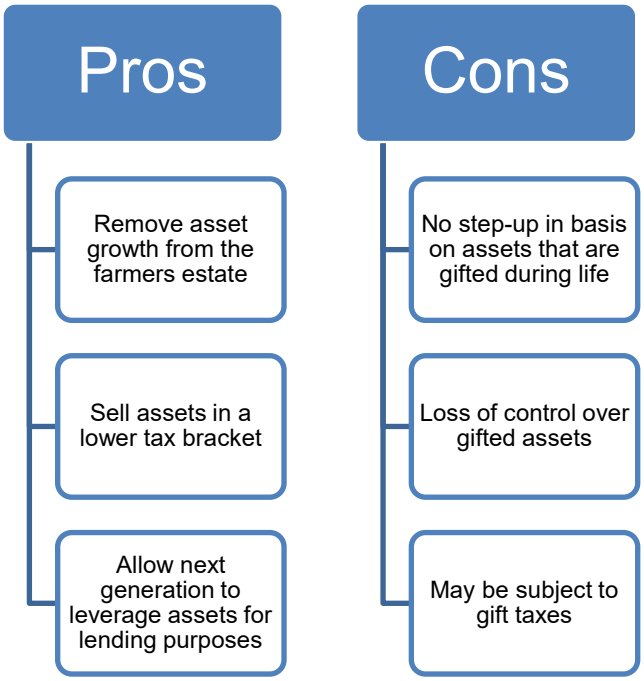
Additional considerations

When considering gifting farm assets, there are also three other large items to address. First, farming is a capital heavy venture generally requiring loans on a yearly basis for operations. For a farmer, this may mean using your farm land as collateral for a loan. For the next generation of farmer these operating loans may be challenging to receive if that farmer does not have collateral to secure the loan. Transitioning assets to the next generation may allow the current owner generation to step out of the active duties of the farm operation.

However, there are also a few disadvantages to consider above the immediate tax implications of the gifted assets. When an asset is gifted, it is no longer in the farmers control. If family friction arises in the future, legal issues, or any other situation that the recipient of that gifted asset runs into results in potential issues for the farm asset that is now in their control. This means that the entire gifted asset is subject to creditor claims which could cause the farm to leave the family's control.

Lastly, while gifting is typically not subject to immediate taxation, there is a potential that gift taxes could be triggered. As noted above, individuals can give away, free from taxation, up to $11.58 million ($22.8 million for married couples) over the course of an individual's life. This exemption from taxation does not apply immediately, it must be reported and documented to take effect. For example, a farm asset is sold from generation 1 to generation 2 that has a value of $750,000. The sale of the asset was made at a stated value of $500,000. This implies that generation 1 made a gift to generation 2 of $250,000. Taking into account the annual exclusion amount, the amount an individual can give tax free per person per year, for 2020 of $15,000, leaves $235,000 subject to gift tax. This $235,000 can be subtracted from generation 1's lifetime exemption amount but must be documented.

Pros and cons to gifting



Summary

When considering gifting assets, it is critical to consider the tax implications of the gift. While no taxes will be owed initial, when that asset is sold taxes could be significant for the party that received the asset. If a farmer has already made a gift of a farm asset there are still options available to consider. Farmers that have received gifted assets can always hold onto the asset until their own death to receive a step up in basis on the asset. The farmer may want to consider gifting the property back. This could provide for a step up in basis on that asset when received as inheritance instead of the initial lifetime gift. Lastly, a farmer can always gift the asset to another party for their use or even give the asset to a charity. There are many options still available if gifting has occurred. Farmers considering gifting should contact their legal and tax professionals to determine how the gift will impact their individual situation.

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