Farm Tax Network™

May 29, 2014

Farmland Sales and Strategies for the 3.8% Tax

This release summarizes a series of strategies for minimizing or defeating the new 3.8% net investment income tax as it affects retirees and landlords disposing of farmland.

Background

Section 1411 imposes a new 3.8% tax on net investment income of individuals, estates and trusts, effective for the tax year beginning in 2013. Investment income includes portfolio income sources such as interest, dividends, royalties and security gains, but also includes rental income and business income that is passive with respect to the taxpayer by reference to Section 469 [Sec. 1411(c)(2)(A)]. In addition to income from rental activities and passive business activities, the 3.8% tax also applies to gains from the disposition of those activities [Sec. 1411(c)(1)(A)(iii)]. This gain provision is particularly harmful to retired farmers who may own land associated with a rental activity or passive business activity.

The 3.8% tax applies to the lesser of the taxpayer's net investment income for the year or the excess of modified AGI (AGI plus the foreign earned income exclusion) over a threshold of $200,000 for single filers and $250,000 for joint filers [Sec. 1411(a)(1) and 1411(b)]. Thus, if the taxpayer's AGI is under $200,000 single or $250,000 joint, the 3.8% tax cannot apply. These thresholds are not indexed for inflation.

Strategy #1: Spread the Gain

If a farmland sale is subject to the 3.8% net investment income tax (NIIT), a cash sale may result in a significant portion of the gain being exposed to the tax. However, an installment sale may allow the seller to report an annual gain amount that keeps AGI below the threshold of the 3.8% tax.

Observation: Seller-financed installment sales should become increasingly common with respect to farmland transactions, not only because of the new 3.8% NIIT, but also because of the new third tier 20% federal capital gain rate. The 20% rate applies to the portion of the gain that exceeds $400,000 of current year taxable income for a single filer or $450,000 for a joint filer. In determining the portion of capital gain subject to the 20% rate, the taxpayer's ordinary income is considered to first fill the lower tax brackets, with capital gain constituting the top portion [Sec. 1(h)].

Example: Art, an active farmer who files jointly, reports $300,000 of ordinary income in his 2013 tax return, consisting of income from his active farming business less itemized deductions and personal exemptions. However, Art also sold a parcel of land he acquired many years ago and that he has been held in rental status. That land sale produces an additional long-term capital gain of $200,000. The entire $200,000 capital gain from the rental property is subject to the 3.8% tax (i.e., the gain from the sale of the rental property is less than the excess of Art's AGI over the $250,000 threshold of the NIIT). Further, with $500,000 of total taxable income (ordinary of $300,000 plus capital gain of $200,000), Art will have $50,000 of the gain reportable at the new 20% rate, representing the portion that is in excess of the $450,000 taxable income threshold of the 20% rate.

Strategy #2: Hold for the Step-up in Basis

As we all know, when assets pass through an estate, the tax basis of those assets is adjusted to the fair market value as of the date of death [Sec. 1014(a)(1)]. As tax rates increase, this so-called step-up in basis becomes more valuable. When we advise our elderly farm clients who might be considering a sale of land, it will be more important to ensure that they are also advised of this step-up in basis rule, and the fact that no capital gain tax occurs if a land sale is deferred until after death. If the landowner's intent is to ensure that specific real estate is made available to an heir or other party for purchase, that objective can be accomplished post-mortem via an option to purchase that is built into the testamentary documents.

Strategy #3: Consider a Section 1031 Exchange

Similarly, as tax rates increase, the value of a like-kind deferred exchange increases. When that 80 year old farm landlord gets sticker shock from the tax projection that we prepare illustrating the capital gain tax and NIIT from the sale of rental land, it is not only important to advise that client of the step-up in basis strategy, but also to advise that an exchange strategy could be a solution. If the land owner has a strong objective of selling currently, such as to get the title of the land into the hands of an heir who actively operates the farming business, an exchange could accomplish both objectives. The sale occurs, but via a qualified intermediary in a Section 1031 transaction. This allows a tax deferred rollover of the funds into other real estate. Note that Section 1031 has a broad definition of like-kind with respect to investment or business real estate. For example, bare farmland can be exchanged into not only other farmland, but improved commercial property as well.

Strategy #4: Sell Shortly after Retirement

Active business owners are exempt from the 3.8% tax when selling property that is part of their business [Sec. 1411(c)(1)(A)(iii)]. Accordingly, if a farm proprietor retires, and shortly thereafter sells machinery and land, those gains are exempt from the 3.8% tax. But how long does the taxpayer have to dispose of those assets before they are no longer considered gains from an active business? If the retiree rents the land for several years and then sells, has the character of the property changed to rental/passive so as to be subject to the 3.8% tax?

The 3.8% tax applies to a business activity's income, as well as gains from that activity, to the extent the activity is passive "within the meaning of Section 469" [Sec. 1411(c)(2)(A)]. Reg. 1.1411-5(a) defines a trade or business subject to the 3.8% tax as a "passive activity with respect to the taxpayer within the meaning of Section 469 and the regulations thereunder." Examples within that regulation refer to the material participation tests under Reg. 1.469-5T(a). Accordingly, we can conclude that the various tests of material participation under Reg. 1.469-5T(a) are available to a taxpayer in determining whether a business activity's income and gains are subject to the NIIT.

A business activity is not considered passive if the taxpayer has materially participated in that activity for any five of the preceding ten years [Reg. 1.469-5T(a)(5)]. Thus, if the real estate was actively used by the taxpayer in the farming business, such as by a Schedule F farm proprietor, and that land is sold within six years, the taxpayer should qualify as a material participant with respect to the gain from the

sale of that business property. This status exempts the gain from the 3.8% tax.

Strategy #5: Farmland Self-rentals

Some farming landowners never directly operate their land because their active farming business is conducted within an entity such as a partnership or corporation. That entity is the tenant, and the individual, or perhaps a limited liability partnership, is the landlord. As a result, the individual, who is materially participating in farming, might own a substantial amount of farmland that has always been held as rental property. While it may appear that this rental real estate is passive and exposed to the 3.8% tax, an important exclusion within the NIIT regulations protects these taxpayers from the 3.8% tax.

The final regulations under Section 1411 hold that net income from self-rental real estate is excluded from net investment income [Reg. 1.1411-4(g)(6)]. This regulation also excludes gain on the sale of self-rental real estate from the NIIT. Self-rental real estate is defined by a cross-reference to the Section 469 regulations. Self-rental real estate is real estate leased to a business activity in which the taxpayer is a material participant under Section 469 [Reg. 1.469-2(f)(6)]. This can include leases to a closely-held C corporation, as well as to a partnership or S corporation or to a spouse's proprietorship.

Example: Bart, who conducts his active farming business within a C corporation, holds ten separate parcels of farmland that are leased to this C corporation. Bart works full time in the C corporation's farming activity and is a material participant. The rental income that Bart collects from his C corporation is self-rental income, and is excluded from the NIIT. Further, if Bart sells a parcel of real estate and recognizes a capital gain, that gain is not subject to the 3.8% NIIT.
Observation: It is not necessary for Bart, in the preceding example, to group the real estate with his business operation. First, the fact that this business operation is conducted within a C corporation prevents grouping of the business and the rental [Reg. 1.469-4(d)(5)(ii)]. If Bart conducted his active business within an S corporation or other pass-through entity, grouping would be permissible. However, there is no benefit to a formal grouping election under Rev. Proc. 2010-13 if Bart expects the farmland rental to continually produce net income. Grouping would only be helpful if the farm rental produced a net loss. In that case, grouping would ensure that any loss was treated as an active business loss rather than a suspended passive loss.

Strategy #6: Special Material Participation Rule for Retired Farmers

The self-rental exemption from the NIIT, discussed in the previous strategy, effectively requires that the taxpayer retain ownership in both the real estate and the business entity. This is solid protection for rental income and gains from the sale of rental land during those years that the land owner is also maintaining an ownership interest and materially participating in the business operating entity. But at retirement, that taxpayer often disposes of ownership in the active business entity while retaining ownership of the real estate in rental status.

There is a special rule, for farmers only, that can extend this NIIT exemption into retirement years. [As an aside, the first five strategies have application to business owners in all industries, not merely ag producers.] The strategy is to have the retiree retain a small ownership interest in the active farming entity (i.e., the family farm partnership or corporation). If that retiree retains a small ownership interest in the operating entity, that individual may be considered a material participant in the entity throughout retirement years and accordingly is self renting the real estate to a business in which he or she materially participates. Thus, both the rental income and any eventual land gain are exempt from the 3.8% tax.

The perceived flaw in this strategy is that normally material participation requires over 500 hours of involvement annually. In some cases that may occur in the first several years following retirement, but it is unlikely to continue for an extended period of years as the landowner advances in age. However,

there is a special exception within Section 469 for farmers. Retiring farmers who were active in the business operation until drawing social security are deemed to be ongoing material participants in the business; this allows the rental income and any land sale gains to avoid the 3.8% tax for that taxpayer's lifetime as long as he retains at least a small ownership in the farm operating business [Sec. 469(h)(3) via cross-reference to Sec. 2032A(b)].

The technicalities are as follows: Sec. 469(h)(3) provides that farm retirees and their spouses are deemed to be materially participating in any farming activity by reference to material participation status under Sec. 2032A(b)(4) or (b)(5). Under those provisions, a taxpayer who is retired, disabled, or a surviving spouse is treated as materially participating if, during the eight years preceding retirement, there were periods aggregating at least five years during which the taxpayer materially participated in the farming activity. In measuring the 5-of-8 year test, the taxpayer may disregard years in which he or she was drawing social security retirement or disability benefits. In summary, if the individual participated 5 of 8 years preceding drawing Social Security retirement benefits, that individual is deemed to be a material participant in the farming entity throughout the period that the individual and surviving spouse are drawing Social Security benefits (i.e., their lifetimes).

Example: Cal actively farmed for many years through his C corporation, but at age 70, Cal retired and began drawing social security benefits. Cal, over the years, had transferred 90% of the stock of the C corporation to his son, Dan; however, Cal continues to own 10% of the C corporation stock. Cal has retained ownership of all of his farmland, and continues to lease that land to the family farm corporation. Because Cal has maintained an ownership in the corporation, and because he began drawing Social Security benefits at the time he ceased actual material participation, he is deemed to be a material participant in the corporation throughout his lifetime under Section 469(h)(3). Cal is considered to be self-renting his land to the family corporation (i.e., he leases land to an entity in which he is a material participant). This deemed material participation and its resulting self-rental status will continue throughout Cal's lifetime, even though he factually is likely to have no participation in the family corporation operating entity in later years.
Observation: Normally, it has been customary for a retiring farmer with a successor to totally divest of ownership in the active operating entity. However, the self-rental exception and the deemed material participation allowed to farmers suggests that some may benefit by continuing to own a small portion of the operating entity into retirement years. This allows the land to remain in self-rental status, and any rental income and any gain on sale to be excluded from the 3.8% tax.

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