Written Statement to the House Agriculture Committee hearing on Agriculture and Tax Reform: Opportunities for Rural America

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Overview

Production agriculture is and has historically been a capital intensive business. The acquisition of land, equipment and livestock 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 famer, he or she must recognize and pay income tax on the gain from that sale. If the exiting farmer gives the assets to the beginning farmer, the beginning farmers receives a carryover income tax basis in the assets and must recognize and 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 recognize and pay income tax on the difference between the exiting farmer's basis and the date-of-death fair market value of the assets.

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. Likewise raised livestock have built-in gains from the increase in numbers and value per head over time. Depreciated operating assets such as purchased livestock, tractors, 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 recognize and pay income tax on the gain. The following proposals 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.

Proposed Tax Law Reforms to Facilitate Transition of Farm Assets

1) Proposal to 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.

A proposed alternative to the one described above is to allow "super funding" of an IRA through a farm sale. Under this proposal, the retiring farmer may sell a farm at fair market value, however recognize the tax consequence of the farm's sale based on the 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 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 while at the same time the retired farmer has income to provide for his/her needs.

2) Proposals 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 might 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:

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 recognizing 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) Proposal for Tax Reporting of Lump-Sum Sales of Farms and Equipment

Some retiring farmers may not be able to take advantage of installment reporting of their gain on sale of their farm because they do not have the means to finance the buyer's purchase of their farm. 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 capital or ordinary.

4) Proposal to retain Like-kind Exchange rules under IRC § 1031

If Congress makes changes to the like-kind exchange rules, they should be retained for transfers of at least some farm real estate 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 gives 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 sales under a certain limit such as $1 million or to family members who must continue farming for a period of time such as 10 years to avoid triggering recognition of the gain.

5) Proposal for Self-Employment Tax on Rental Income

Under current law, exiting farmers who rent their farmland to entering farmers and stay active in the farming business must pay self-employment tax on their net rent. This makes it harder for exiting farmers to transfer the use of their land to entering farmers by renting it to them. By contrast, owners of other real property, such as a warehouse used in a business, are not subject to self-employment tax on the net rent they receive from the warehouse whether or not they stay active in the business that rents the warehouse from them.

This disparity can be eliminated by removing the self-employment tax on rent received by a landowner who materially participates in the production of agricultural or horticultural commodities on his or her land.

Discussion of Proposal for Self-Employment Tax on Rental Income

I.R.C. § 1401(a) imposes a 12.4% tax on up to $127,200 (for 2017) of self-employment income. This is alternatively referred to as the "old age, survivor and disability insurance" or as the "social security" tax.

I.R.C. § 1401(b) imposes a 2.9% tax on all self-employment income. This is alternatively referred to as the "hospital insurance" or the "Medicare" tax.

The combination of the above two taxes is 15.3% on the first $127,200 of self-employment income in 2017 (this figure is indexed for inflation and therefore increases each year by the increase in the consumer price index.) and 2.9% on self-employment income above $127,200 (in 2017). The combination of the two taxes is often referred to as the "self-employment" tax. Note that the self-employment tax is similar to the FICA tax that is imposed on an employee's wages. The combination of the employee's (7.65%) and employer's (7.65%) shares of the FICA tax equals the 15.3% self-employment tax.

I.R.C. § 1402(b) defines "self-employment income" as "net earnings from self-employment" with some exceptions that are not important to this discussion.

I.R.C. § 1401(a) defines "net earnings from self-employment" as all income from a trade or business" with several exceptions. The exception of interest to this discussion is set out in I.R.C. § 1402(a)(1). That exception excludes rent paid on real estate and on personal property rented with the real estate. However, there are two exceptions to the exception, one of which is for income derived by an owner of land if:

a. there is an arrangement under which another person will produce agricultural or horticultural commodities on the land and the owner will materially participate in the production or management of the production of the agricultural or horticultural commodities, and

b. the owner actually materially participates in the production or management of the production of the agricultural or horticultural commodity.

The effect of this provision is a disparity in the self-employment tax treatment of rent paid for farmland and rent paid for other real property.

Example. *Farmer Bill owns 400 acres of farmland that he rents to his daughter under a cash lease that requires Bill to help her make management decisions. After paying property taxes, insurance and maintenance, Bill realizes $100,000 of net income from the land each year. Under current law, Bill must pay $15,300 ($100,000 × 15.3%) of self-employment taxes on that income.*

Contractor Kari owns a warehouse that she rents to her son under a cash lease. After paying property taxes, insurance and maintenance, Kari realizes $100,000 of net income from the warehouse each year. Because the rent is not from land used in farming, Kari does not have to pay self-employment tax on the rent.

The proposed change in the law would eliminate the self-employment tax on Bill's net rental income so that he and Kari would be taxed the same.

This provision (the farmland exception to the real estate exception) was added to the Internal Revenue Code in 1956. At that time, farmers who were at the retirement age had paid into the social security system for only a short time and qualified for little or no social security benefits. The provision allowed them to build up their social security benefits after they quit farming by making the rent they received subject to the self-employment tax and therefore to be counted as social security earnings. Most farmers who retire today have built up social security earnings that qualify them for social security benefits and there is no need for them to pay social security tax on their rental income after retiring from farming.

The proposed amendment will solve the self-employment tax problem not only for farmers who retire and want to participate in the production on their land but also for farmers who rent their farmland to their farming business entity. The IRS and the Tax Court think the current law requires such landowners to pay self-employment tax on the rent they receive from their business entity. See *Mizell v. Commissioner*, T.C. Memo 1995-571; Letter Ruling 9637004; *Bot v. Commissioner*, TC Memo 1999–256; *Hennen v. Commissioner*, TC Memo 1999–306; and *McNamara v. Commissioner*, TC Memo 1999–333.

In *McNamara v. Commissioner*, 236 F.3d 410 (8th Cir. 2000), the Eighth Circuit Court of Appeals disagreed with the IRS and the Tax Court and held that rent paid by the taxpayer's corporation to the taxpayer for land owned outside the corporation is not subject to self-employment tax if the rent is set at a fair rental rate. In Action on Decision 2003-003, the IRS stated that it will follow the holding of the *McNamara* case in the Eighth Circuit. However, the IRS did not acquiesce to the Eighth Circuit's decision and will continue to litigate its position in cases in other circuits. The proposed amendment would eliminate the IRS argument that rent paid from an entity for land held outside the entity is subject to self-employment tax and therefore end the disparate treatment of taxpayers inside and outside the Eighth Circuit.

6) Proposal to retain Step-up in Basis to Fair Market Value at Death

If Congress repeals the Estate Tax it is proposed to keep the step-up in basis rules found in I.R.C. § 1014 similar to the rules of 2010 which allowed modified step-up on selected assets. This proposal would help to ensure the ability to settle estates where certain assets might be sold, with little to no tax consequence, to make equitable distributions amongst heirs.

7) Proposal to 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 beneficiary (envisioned to be young beginning farmer/rancher) as well as others 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.

For this benefit some specific proposed rules:

a) The beneficiary would not receive basis for the amount used in the down payment which came from this proposed account. For example: Joe Beginner used $100,000 from his

special farm down payment account to buy a farm priced at $300,000. Joe's basis in the farm is $200,000 which is allocated in a *pro rata* manner to land and improvements similar to IRC § 1060 rules.

c) If the beneficiary disposes of the property, except through a like-kind exchange with the purpose to continue farming, within a 10-year period from date of purchase, the tax deferred savings of the down payment is recaptured in full, similar to IRC § 2032A rules for estate special use valuation.

8) Replace the Income, FICA, and SECA Taxes with the FAIR Tax

The FAIR tax (HR25/S18) would remove all the tax impediments to farm transition.

Conclusion

In 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 law impacts this transfer and often creates impediments to both parties and therefore these transfers do not occur. Tax reform can facilitate transfers prior to death of the exiting farmer.

This ends the written testimony of Guido van der Hoeven.