



Farm Tax and Farm Sales Affected by New Fiscal Cliff Legislation

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Congress passed the American Taxpayer Relief Act of 2012 (ATRA) on January 1, 2013 and with President Obama's signature the following day, ATRA ushered in broad new tax laws for 2013 onward. While ATRA's tax changes are extensive and many of these changes will affect farmers, this article will point out the changes that may have the most impact on the farmer's income tax bill.

Note. While this article refers specifically to farmers, the tax changes discussed in this article also apply to other taxpayers.

i. Tax Bracket Changes

One major change ATRA brings for 2013 and subsequent years is a new top tax bracket. The new bracket applies to income above \$400,000 (for farmers filing as single) or \$450,000 (for married farmers filing jointly). The new tax rate on income in the new top bracket is 39.6%.

Farmers with incomes below the \$400,000 or \$450,000 thresholds are not affected by this change, since ATRA did not make any changes to the lower tax brackets.

Note. Farmers will be filing their 2012 tax return based on the 2012 tax brackets. The new ATRA brackets and rates, including the new top tax bracket, are effective starting with the 2013 tax year. The new ATRA brackets and tax rates will therefore affect farmers' returns that are filed in early 2014 in connection with the 2013 tax year.

While the new top tax bracket is a major ATRA change, there are some other additional ATRA changes that will affect the farmer's tax liability each year from 2013 onward.

ii. A Return to Itemized Deduction Limits

Through 2009, higher-income farmers frequently saw their itemized deductions reduced because their income was high enough to trigger a limitation formula. This meant a higher tax bill for the year. After a

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three-year hiatus, ATRA brings this limit on itemized deductions back into effect for higher-income farmers for 2013 and subsequent years. The limitation affects farmers with adjusted gross income (AGI) over a threshold amount (\$250,000 for farmers filing single or \$300,000 for farmers filing jointly).

Generally, farmers affected by this rule will have their itemized deductions reduced by 3% of the amount by which AGI exceeds the threshold amount. The reduction is subject to a “cap” that is part of the formula which is triggered if the farmer’s income is high enough.

Example 1. Lisa is a single farmer with 2013 net Schedule F income in the amount of \$600,000, which is also the amount of her AGI. She also has \$33,000 of allowable itemized deductions, comprised of her charitable contributions, mortgage interest and \$3,000 of medical expenses. Because her income is over the \$250,000 threshold for single filers, she will have reduced tax benefit from her itemized deductions.

Lisa’s \$600,000 AGI exceeds her \$250,000 threshold amount by \$350,000. Lisa’s itemized deductions will be reduced by \$10,500 ($3\% \times \$350,000$). Her total itemized deductions for 2013 will be $\$33,000 - \$10,500 = \$22,500$. This means that for 2013, Lisa will only be able to claim \$22,500 of the \$33,000 in itemized deductions that would otherwise be allowable.

Note. The \$250,000 and \$300,000 single filer and joint filer AGI threshold amounts are subject to annual inflation increases for 2014 and subsequent years.

iii. A Return to the Personal Exemption Phaseout

Higher-income farmers also saw a reduction to their personal exemption amount through the 2009 tax year. Personal exemption amounts remained fully intact from 2010 through 2012, but ATRA brings back this reduction of the farmer’s personal exemption for 2013 and subsequent tax years. The personal exemption amount is also reduced according to a formula. Generally, for each \$2,500 (or remaining fraction of \$2,500) of AGI the farmer has that in excess of the AGI threshold, the personal exemption amount is reduced by 2%. The AGI threshold amounts used are the same ones mentioned in the previous section regarding the itemized deduction limitation.

Example 2. Kevin and Joy are husband and wife farmers that file jointly. Their joint AGI is \$305,010 for 2013. The personal exemption amount for 2013 is \$3,900. Kevin and Joy have a personal exemption amount for each spouse, which amounts to \$7,800 ($2 \times \$3,900$) before any limitation. Because Kevin and Joy have AGI in excess of the \$300,000 threshold for joint filers, their personal exemption amount will be reduced. The amount of AGI they have in excess of the \$300,000 joint filer threshold is \$5,010 ($\$305,010 - \$300,000$). Their personal exemption amount will be reduced in accordance with the following steps.

Step 1. Determine how many times \$2,500 divides evenly into the amount of AGI in excess of the threshold and determine if there is a remainder (if \$2,500 does not divide evenly into that excess income amount). If there is a remainder, the result gets increased to the next largest whole number. In this case, $\$5,010 \div \$2,500 = 2.004$, or 3.

Step 2. Multiply the increased result by 2% to obtain the total percentage reduction for the itemized deductions. The total percentage reduction is $3 \times 2\% = 6\%$. Kevin and Joy must reduce their personal exemption amount that would otherwise be allowable by 6%.

The \$7,800 personal exemption for Kevin and Joy will be reduced by \$468 ($6\% \times \$7,800$).

iv. Changes in Capital Gains Rates

As explained previously, ATRA creates a new top tax bracket with a 39.6% tax rate that applies to income over \$400,000 for single taxpayers (\$450,000 for joint filers). Among the new ATRA tax changes is an increase in the top capital gains rate from 15% to 20% that applies to those farmers in the new top 39.6% brackets. This increased capital gains rate applies to each tax year starting with 2013.

The Impact of ATRA

ATRA has many provisions that may have an effect on a farmer’s income tax liability each year beginning

with 2013 but the following example illustrates the impact of those changes discussed above.

Example 3. Brett is a single farmer with \$600,000 of Schedule F net income for 2013. During 2013, he sold some farmland and has a long term capital gain in the amount of \$800,000 from the sale. In addition, he has \$60,000 in itemized deductions comprised of deductible interest and charitable donations). In the earlier discussion regarding ATRA tax bracket changes, the new ATRA tax brackets and the “non-ATRA” brackets (which would have prevailed for 2013 without the ATRA legislation) were presented. This allows some comparative “ATRA vs. non-ATRA” tax calculations to be made to determine the impact of these changes on Brett’s tax liability for 2013. The following table compares the highlights of the detailed tax calculations for Brett.

	2012 Sale Without ATRA	2013 Sale With ATRA
Schedule F net income	\$ 600,000	\$ 600,000
Long term capital gain	<u>800,000</u>	<u>800,000</u>
Total income	1,400,000	1,400,000
Less: Self-employment tax deduction	<u>(14,859)</u>	<u>(15,084)</u>
AGI	<u>1,385,141</u>	<u>1,384,916</u>
Less: allowed itemized deductions	(60,000)	(25,953)
Less: personal exemption	<u>(3,800)</u>	<u>-</u>
Taxable income	\$ 1,321,341	\$ 1,358,963
Income tax on farming income	\$ 159,230	\$ 179,113
Capital gains tax on sale of farmland	<u>120,000</u>	\$ 160,000
Total tax liability	\$ 279,230	\$ 339,113

Because of the impact of the ATRA changes discussed, Brett will pay an additional \$59,883 in taxes for 2013. This increased tax liability is due to the following ATRA changes:

- A substantially reduced itemized deduction amount
- A personal exemption amount that is reduced to zero
- Additional tax on farming income that falls into the top tax bracket with a 39.6% rate (which would not be paid if the top tax bracket remained at 35%)
- Additional capital gains tax from the new 20% rate which would not be paid if the top capital gains tax rate remained at 15%

Note. While some of the \$59,883 difference in tax liability calculated above is attributable to the indexing of tax brackets for inflation from 2012 to 2013, this amount is minimal (under \$500).

Don't Forget the New Medicare Taxes

Effective January 1, 2013, two new Medicare taxes may affect the farmer’s overall tax liability too. These Medicare taxes are not attributable to ATRA but came into effect for 2013 as a result of the Affordable Care Act which passed into law in March, 2010. Generally, these two new taxes may affect farmers with modified adjusted gross income over the threshold amount of \$200,000 (\$250,000 for farmers filing jointly). Briefly, these two new Medicare taxes can be summarized as follows:

- An additional 3.8% tax on “net investment income” for farmers over the threshold amount,¹ and
- An additional 0.9% on earned income in excess of the threshold amount.²

Under proposed IRS regulations, if the sale of farmland is considered to be a disposition of property held

in a trade or business in which the farmer meets the “material participation” requirement,³ capital gain resulting from the sale is not considered “net investment income” and will not be subject to the 3.8% Medicare tax. However, if the sale of farmland is considered to be the sale of property from a passive activity in which the farmer does not meet the material participation requirement, the 3.8% Medicare tax will apply to the amount of the resulting net capital gain in excess of the farmer’s threshold amount.

Moreover, the additional 0.9% Medicare tax will apply on the farmer’s net farming income that falls above the threshold.

Example 4. Use the same facts as Example 3. The farmland that Brett sold was not land that Brett actively farmed but was land that he held for investment purposes. Brett does not meet the “material participation” requirement and the sale is considered to be the sale of property from a passive activity. Brett will have additional tax liability as a result of the 3.8% Medicare tax on net investment income on the \$800,000 of net long term capital gain. Under the rules for the new 3.8% Medicare tax on net investment income, the entire \$800,000 of capital gain is subject to the tax. His additional tax liability on the sale is \$30,400 (3.8% × \$800,000).

Moreover, Brett’s net farming income in the amount of \$600,000 shown on Schedule F is in excess of the \$200,000 threshold. Brett will owe additional Medicare tax on his adjusted self-employment income in excess of the \$200,000 threshold. The amount of Brett’s self-employment income subject to the new Medicare tax is calculated as follows.

Amount of self-employment income from farming	\$ 600,000
Taxable self-employment income subject to SE tax (self-employment income X 0.9235)	\$ 554,100
Less: Exemption (threshold amount)	<u>\$(200,000)</u>
Amount subject to 0.9% Medicare tax	\$ 354,100

Note. The amount of self-employment income subject to self-employment tax is 92.35% of self-employment income. Multiplying self-employment income by a factor of 0.9235, as shown above, makes this adjustment. See Publication 225, *Farmer’s Tax Guide* and Schedule SE, *Self-Employment Tax* for further details on this adjustment.

The additional amount of Medicare tax on self-employment income that Brett owes is \$3,167 (0.9% × \$354,100).

Note. Further information on the new Medicare taxes and how they apply to farming income and sales may be found in an earlier Farmdoc article entitled “*Farms and the New 2013 Medicare Tax Increases*” (Oct. 26, 2012). This article also discusses the “material participation” requirement.

Conclusion

ATRA consists of many changes that may increase a farmer’s tax liability for 2013 onward. Higher-income farmers are primarily affected. In addition, the new rules may increase tax liability on farming activity income as well as the farmer’s tax liability on capital gains. The two new Medicare taxes (one that applies to earned income and one that applies to investment income, such as capital gains) may further increase the farmers tax liability in addition to those increases attributable to ATRA. Farmers should consult their tax advisor on the best strategies to minimize the impact of these new tax rules that become effective in 2013.

References

¹ The IRS has issued proposed regulations regarding the 3.8% Medicare tax on net investment income. See REG-130507-11, Federal Register Vol. 77, No. 234 (Dec. 5, 2012).

² The IRS has issued proposed regulations regarding the 0.9% Medicare tax on net investment income. See REG-130074-11, 2012-52 IRB 790 (Dec. 27, 2012).

³ See IRC §469 and Treas. Reg. §1.469-5T and Prop. Reg. §1.1411-5.