THE COST OF RETIRING

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Most farmers invest everything they can into their farm and equipment, and their operation is their largest asset and their retirement plan. When the day finally arrives, many farmers intend to sell those assets and live on the proceeds. There may be a significant income tax liability on the disposition of those assets.

If the farmer has been successful over the years and can afford to transfer the farm to the children, then there will be no income tax issues for the farmer, but there may be an effect on the children. It may be necessary to consider gift or estate tax issues if the operation is large.

The issue is that selling assets for more than their basis generates taxable income. Land has probably increased in value since it was acquired and the sale will generate a long-term capital gain. The sale of machinery and equipment is a bigger problem. Machinery is usually depreciated faster than the decrease in value; so, when it is sold it creates a depreciation recapture that is taxed as ordinary income. To compound the problem, the greater the value of the assets sold in one year, the higher the tax bracket.

Generally, spreading income over several years produces an advantage over selling in one year because it reduces the average annual income which lowers the tax bracket for the farmer. Four scenarios will be discussed in this paper: (1) selling the land and machinery during the year of the last harvest; (2) selling the machinery and equipment (depreciable assets) in one year and the land (non-depreciable assets) in the next year; (3) selling the machinery and equipment in one year and the land with an installment note; and (4) selling the land with an installment note and contributing the equipment to a limited partnership that does custom hire work.

Some individuals will “die with their boots on,” some will sell it all and move to Florida, and some will effect a smooth transition over many years. Choices about where and how long a person works, business succession plans, and retirement plans depend on health, wealth, age, and personal objectives. Income and estate tax can have a dramatic effect on the transfer. Farmers should seek tax counsel before starting their transition plan. The scenarios below illustrate a 25 percent difference between the worst and best strategy.

Case Study

The following case study compares the after-tax results of four asset transfer strategies. The example used is an agricultural business that is a combination of crop and livestock production. The business has income and expenses and depreciable and non-depreciable assets like any non-farm business. The analysis does not examine alternative investments or the present value of the after-tax proceeds from the sale.

John Q. and Mary M. Farmer are both age 65, and they have been successfully operating their farm for more than 30 years. They operate as a sole proprietorship. A neighbor wants to buy their farm when they are ready to retire. The Farmers have acquired land, buildings, machinery, equipment, vehicles, and livestock (both purchased and raised) over several years. Table 1 lists their assets with their fair market value, cost basis, accumulated depreciation, adjusted basis, and potential gain from disposition.

Table 1. The Farmer's assets with their current value, original cost, accumulated depreciation, adjusted basis the amount of gain or loss on the disposition and whether the gain or loss is ordinary or long-term capital.

Asset Description	Market Value	Cost Basis	Accumulated Depreciation	Adjusted Basis	Gain/Loss	§ 1245 Re-capture	§ 1231 Gain
Purchased breeding livestock	25,000	27,500	20,250	7,250	17,750	17,750	
Machinery & equipment	425,000	525,000	435,525	89,475	335,525	335,525	
Single-purpose structures	100,250	125,000	88,750	36,250	64,000	64,000	
Total depreciable assets	550,250	677,500	544,525	132,975	417,275	417,275	
Raised breeding livestock	175,000	0	0	0	175,000		175,000
Farm & pasture land	535,750	125,500	0	125,500	410,250		410,250
Total land &livestock	710,750	125,500	0	125,500	585,250		585,250
Total assets	1,261,000	803,000	544,525	258,475	1,002,525	417,275	585,250

Mary has been a substitute teacher at the local school. She expects her Form W-2 income for 2015 to be $8,712. John expects the net profit from the farming operation in 2015 to be $60,539. Based on that information, their gross income would be $69,251. John would get an above-the-line deduction for half of his self-employment tax of $4,277 resulting in an adjusted gross income of $64,974. John and Mary claim the standard deduction of $15,100 (since they are 65 years of age) and an $8,000 personal exemption resulting in a taxable income of $41,874 and an income tax liability of $5,359. John also owes self-employment tax (FICA) of $8,554 for a total tax liability of $13,913. This leaves them $55,338 for living expenses.

After retiring, John and Mary will start drawing their Social Security. We will assume that John has earned a $2,100 per month benefit and Mary has earned a $900 per month benefit. They will also withdraw $1,000 per month from an IRA to produce a retirement income of $48,000 per year. We will assume that after retiring that John and Mary will need living expenses of $55,000 per year which will increase by 2% each year.

To make the four variations somewhat comparable, each scenario includes a 10-year analysis. Taxes were calculated with a professional tax return preparation package (Drake 2015 Tax Software); therefore, all future numbers are calculated using 2015 tax tables. Income beyond living expenses are assumed to earn 2.5% interest annually.

Case 1. Lump-Sum Cash Sale in the Last Year of Operation

The first scenario involves selling all of the farm assets during the last year of operation; in this case, 2015. This scenario produces the most income in one year which puts the Farmers into the highest tax bracket, 39.6%. The results are shown in Table 2 below.

The depreciable assets sold for $550,250, but because of the remaining basis, the gain was only $417,275. Since the assets all sold for less than their purchase price the entire $417,275 was depreciation recapture which is taxed at ordinary income tax rates, not capital gain. The non-depreciable assets were taxed at long-term capital gains rates. However, because the income from the sale of the machinery and equipment pushed the Farmers into the 39.6% bracket, all of the capital assets were taxed at 20%. In addition, the 2015 income phased out the Farmer's personal exemption. After selling their assets for $1,261,000 and earning $69,251 and deducting taxes, $256,926, and living expenses, $55,000, the Farmers were left with $1,018,325.

After the first year, the Farmer's income consists of Social Security, IRA withdrawals and interest on the proceeds of the sale. Only $15,739 of the $36,000 Social Security payment is taxable in 2016 and beyond. Therefore, Gross income (for calculating income tax) is not the total of investment income and retirement income, but investment income, IRA withdrawals, ($12,000 per year) and $15,739 of taxable Social Security payments. Income is the total income received, and therefore, investment income plus retirement income.

After 10 years, the Farmers will have accumulated $1,107,429.

Adjusted Gross Income is abbreviated as AGI for the remainder of the paper.

Table 2. Tax calculations for selling the farm assets during the last year of operation					
	2015	2016	2017	2018	2019
Mary's wages	$8,712				
Farm income	60,539				
Depreciation recapture	417,275				
Capital gain	585,250				
Investment income		25,458	25,802	26,125	26,424
Retirement income		48,000	48,000	48,000	48,000
Gross income	1,071,776	53,197	53,834	54,431	54,984
½ of SE tax	4,277				
AGI	1,067,499	53,197	53,834	54,431	54,984
Standard deduction	15,100	15,100	15,100	15,100	15,100
Exemption	0	8,000	8,000	8,000	8,000
Taxable income	1,052,399	30,097	30,734	31,331	31,884
Tax on ordinary income	130,907	3,589	3,686	3,776	3,859
Tax on capital gain	117,050				
Alt. min. tax	415				
SE tax	8,554				
Total tax	256,926	3,589	3,686	3,776	3,859
Living expenses	55,000	56,100	57,222	58,366	59,534
Asset sale	1,261,000				
Income	69,251	73,458	73,802	74,125	74,424
Remainder	1,018,325	13,769	12,894	11,982	11,031
Accumulation	1,018,325	1,032,094	1,044,988	1,056,971	1,068,002

For readability, the 10-year tables are broken into two 5-year increments. Categories that do not appear in the second 5 years were deleted from the continuation table, e.g. Mary's wages, farm income, depreciation recapture, etc.

Table 2 (continued). Tax calculations for selling the farm assets during the last year of operation					
	2020	2021	2022	2023	2024
Investment income	26,700	26,951	27,176	27,374	27,545
Retirement income	48,000	48,000	48,000	48,000	48,000
AGI	55,495	55,959	56,376	56,742	57,058
Standard deduction	15,100	15,100	15,100	15,100	15,100
Exemption	8,000	8,000	8,000	8,000	8,000
Taxable income	32,395	32,859	33,276	33,642	33,958
Tax on ordinary income	3,934	4,009	4,069	4,121	4,174
Total tax	3,934	4,009	4,069	4,121	4,174
Living expenses	60,724	61,939	63,178	64,441	65,730
Income	74,700	74,951	75,176	75,374	75,545
Remainder	10,042	9,003	7,929	6,812	5,641
Accumulation	1,078,044	1,087,047	1,094,976	1,101,789	1,107,429

Case 2. Cash Sale Over Two Years

The second scenario attempts to reduce the annual tax liability by spreading the sale over two years, depreciable assets in December 2015 and non-depreciable property in January 2016. The tax on the ordinary income is the same as the first case; so, the marginal tax rate reaches the 39.6% bracket. By moving the capital asset sale to the next year, the AGI does not reach the 39.6% bracket; so, the capital gains rate is 15% and the long-term capital gain tax drops from $117,050 to $90,198; however, because of the high AGI, the alternative minimum tax kicks in to add back $9,043 of the savings.

The tax savings is $17,809 but investment income in 2016 is $14,832 less than in the first case so the increase in accumulated income after 10 years is only $2,515.

Table 3. Tax calculations for selling the depreciable assets in 2015 and the non-depreciable assets in 2016					
	2015	2016	2017	2018	2019
Mary's wages	$8,712				
Farm income	60,539				
Depreciation recapture	417,275				
Capital gain		585,250			
Investment income		10,626	25,857	26,180	26,481
Retirement income		48,000	48,000	48,000	48,000
Gross income	486,526	638,476	53,935	54,553	55,090
½ of SE tax	4,277				
AGI	482,249	638,476	53,935	54,553	55,090
Standard deduction	15,100	15,100	15,100	15,100	15,100
Exemption	0	0	8,000	8,000	8,000
Taxable income	467,149	623,376	30,835	31,453	31,990
Tax on ordinary income	130,907	4,796	3,701	3,791	3,874
Tax on capital gain		90,198			
Alt. min. tax		9,043			
SE tax	8,554				
Total tax	139,461	104,037	3,701	3,791	3,874
Living expenses	55,000	56,100	57,222	58,366	59,534
Asset sale	550,250	710,750			
Income	69,251	58,626	73,857	74,180	74,481
Remainder	425,040	609,239	12,934	12,023	11,073
Accumulation	425,040	1,034,279	1,047,213	1,059,236	1,070,309

Table 3 (continued). Tax calculations for selling the depreciable assets in 2015 and the non-depreciable assets in 2016					
	2020	2020	2022	2023	2024
Capital gain					
Investment income	26,758	27,101	27,236	27,435	27,606
Retirement income	48,000	48,000	48,000	48,000	48,000
AGI	55,602	56,069	56,487	56,855	57,171
Standard deduction	15,100	15,100	15,100	15,100	15,100
Exemption	8,000	8,000	8,000	8,000	8,000
Taxable income	32,502	32,969	33,387	33,755	34,071
Tax on ordinary income	3,956	4,024	4,084	4,144	4,189
Total tax	3,956	4,024	4,084	4,144	4,189
Living expenses	60,724	61,939	63,178	64,441	65,730
Income	74,758	75,010	75,236	75,435	76,606
Remainder	10,077	9,047	7,974	6,850	5,687
Accumulation	1,080,386	1,089,433	1,097,407	1,104,257	1,109,944

Case 3. Installment Sale of Non-Depreciable Assets

The third scenario attempts to spread the sale proceeds over ten years, but only for non-depreciable assets. Section 1245 property means property which has been depreciated under Section 167 (ordinary depreciation). The rule in 1245 requires that the difference between the sales price and the adjusted basis be claimed as ordinary income (depreciation recapture) in the year of disposition. This rule applies even though the proceeds are received over a number of years. In other words, the entire $417,275 of depreciation recapture must be claimed as ordinary income in the year of sale whether the money is received or not. Therefore, only the installment payments for the non-depreciable assets will have an effect in this Case.

Table 4 shows the effect of selling the depreciable assets in 2015 and selling the non-depreciable assets with a 10% down payment in 2015 and the remainder financed over nine years. For non-dealer dispositions that are not subject to 1245 treatment (non-depreciable assets) the amount of capital gain is reported in equal increments which are the gross profit ratio times the annual payment, or in this Case $58,525. An interest rate of six percent was used to calculate the interest on the note.

Table 4. Tax calculations for selling the depreciable assets in 2015 with an installment sale of the non-depreciable assets over 9 years.

	2015	2016	2017	2018	2019
Mary's wages	$8,712				
Farm income	60,539				
Depreciation recapture	417,275				
Capital gain	58,525	58,525	58,525	58,525	58,525
Interest on note		38,380	35,146	31,717	28,083
Investment income		12,314	14,328	16,377	18,461
Retirement income		48,000	48,000	48,000	48,000
Gross income	545,051	151,819	150,599	149,219	147,669
½ of SE tax	4,277				
Adjusted gross income	540,774	151,819	150,599	149,219	147,669
Standard deduction	15,100	15,100	15,100	15,100	15,100
Exemption	0	8,000	8,000	8,000	8,000
Taxable income	525,674	128,719	127,499	126,119	124,569
Tax on ordinary income	130,907	9,604	9,424	9,214	8,981
Tax on capital gain	11,705	8,073	7,890	7,683	7,450
Alt. min. tax	415				
SE tax	8,554				
Total tax	143,027	17,677	17,314	16,897	16,431

Living expenses	55,000	56,100	57,222	58,366	59,534
Asset sale	621,325	55,666	59,006	62,546	66,299
Income	69,251	98,694	97,474	96,094	94,544
Remainder	492,549	80,583	81,944	50,361	84,879
Accumulation	492,549	573,132	655,076	631,238	823,331

Table 4 (continued). Tax calculations for selling the depreciable assets in 2015 with an installment sale of the non-depreciable assets over 9 years.

	2020	2021	2022	2023	2024
Capital gain	58,525	58,525	58,525	58,525	58,525
Interest on note	24,231	20,147	15,818	11,230	6,367
Investment income	20,583	22,745	24,947	27,193	29,486
Retirement income	48,000	48,000	48,000	48,000	48,000
AGI	145,939	144,017	141,890	139,548	136,978
Standard deduction	15,100	15,100	15,100	15,100	15,100
Exemption	8,000	8,000	8,000	8,000	8,000
Taxable income	122,839	120,917	118,790	116,448	113,878
Tax on ordinary income	8,726	8,434	8,119	7,766	7,384
Tax on capital gain	7,191	6,903	6,584	6,232	5,847
Total tax	15,917	15,337	14,703	13,998	13,231
Living expenses	60,724	61,939	63,178	64,441	65,730
Asset sale	70,277	74,494	78,963	83,701	88,723
Income	92,814	90,892	88,765	86,423	83,853
Remainder	86,450	88,109	89,848	91,685	93,615
Accumulation	909,781	997,890	1,087,738	1,179,423	1,273,038

The increase in accumulated earnings for Case 3 over Case 2 was $163,094. Long-term capital gains tax was reduced by $23,683 in Case 3 although the total tax for Case 3 was $9,271 more. The investment earnings at 2.5% were less for Case 3; however, the interest on the note at 6% more than made up the difference.

The capital gain was the same each year, but the capital gains tax decreased slightly each year. When calculating the long-term capital gain tax, if the ordinary income is less than $74,900 for married filing jointly, the amount less than $74,900 is taxed at 0% instead of 15%.

Case 3 shows the advantage of spreading income over several years to reduce the marginal tax rate.

Case 4. Installment Sale of Non-Depreciable Assets and Contribute Depreciable Assets to a Limited Partnership

In Case 3 the non-depreciable assets were sold with an installment note and the effect was significant. The 1245 rules reduce the benefit of using an installment note for depreciable assets. In Case 3, the benefit was completely eliminated.

Section 1245(b)(3) provides an exception to depreciation recapture if the basis in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of Section 721. Section 721 provides for no gain or loss recognition when transferring assets to a partnership in exchange for a partnership interest.

In Case 4, John Farmer contributes his depreciable assets to a limited liability limited partnership that does custom hire work in exchange for a limited partnership interest. The potential buyer of the farm happens to be the general partner and he contributes $550,250 for his 50% interest in the limited partnership.

The limited partnership pays John Farmer a 6% return on his investment in the partnership. Because John is a limited partner the money he receives is not income from self-employment. In addition, the partnership agreement allows John to withdraw 11.11% of his initial interest each year for 9 years beginning in 2016.

The non-depreciable assets are sold with an installment note the same as in Case 3. The resulting numbers from John's projected tax returns using 2015 tax tables is shown in Table 5.

Table 5. Tax calculations for contributing the depreciable assets to a limited partnership in 2015 with an installment sale of the non-depreciable assets over 9 years.

	2015	2016	2017	2018	2019
Mary's wages	$8,712				
Farm income	60,539				
Capital gain	58,525	58,525	58,525	58,525	58,525
Depreciation recapture		46,364	46,364	46,364	46,364
Interest on note		38,380	35,146	31,717	28,083
Interest from LP		33,015	29,347	25,678	22,010
Investment income		1,690	5,473	9,019	12,676
Retirement income		48,000	48,000	48,000	48,000
Gross income	127,776	220,574	217,339	213,903	210,258
½ of SE tax	4,277				
AGI	123,499	220,574	217,339	213,903	210,258
Standard deduction	15,100	15,100	15,100	15,100	15,100
Exemption	8,000	8,000	8,000	8,000	8,000
Taxable income	100,399	197,474	194,239	190,803	187,158
Tax on ordinary income	5,359	26,325	25,516	24,657	23,746
Tax on capital gain	3,825	8,779	8,779	8,779	8,779
SE tax	8,554				
Total tax	17,738	35,104	34,295	33,436	32,525
Living expenses	55,000	56,100	57,222	58,366	59,534
Asset sale	71,075	116,805	120,145	123,685	127,438
Income	69,251	121,085	117,850	114,414	110,769
Remainder	67,588	146,686	146,478	146,297	146,148
Accumulation	67,588	214,274	360,751	507,048	653,196

Table 5 (continued). Tax calculations for contributing the depreciable assets to a limited partnership in 2015 with an installment sale of the non-depreciable assets over 9 years.					
	2020	2021	2022	2023	2024
Capital gain	58,525	58,525	58,525	58,525	58,525
Depreciation recapture	46,364	46,364	46,364	46,364	46,364
Interest on note	24,231	20,147	15,818	11,230	6,367
Interest from LP	18,342	14,673	11,005	7,337	3,668
Investment income	16,330	14,981	23,630	27,278	30,927
Retirement income	48,000	48,000	48,000	48,000	48,000
AGI	206,391	202,290	197,942	193,334	188,451
Standard deduction	15,100	15,100	15,100	15,100	15,100
Exemption	8,000	8,000	8,000	8,000	8,000
Taxable income	183,291	179,190	174,842	170,234	165,351
Tax on ordinary income	22,779	21,754	20,667	19,515	18,294
Tax on capital gain	8,779	8,779	8,779	8,779	8,779
Total tax	31,558	30,533	29,446	28,294	27,073
Living expenses	60,724	61,939	63,178	64,441	65,730
Asset sale	131,416	135,633	140,102	144,840	149,862
Income	106,902	102,801	98,453	93,845	88,962
Remainder	146,036	145,962	145,932	145,950	146,021
Accumulation	799,232	945,194	1,091,126	1,237,076	1,383,096

Case 4 improves on Case 3 by $110,058 of additional accumulated income. The total tax is $15,470 greater for Case 4 because there is more ordinary income; however, the additional interest income from the limited partnership more than makes up the difference.

Assets withdrawn from a limited partnership normally qualify for long-term capital gain treatment. In this case, the gain is re-characterized as depreciation recapture and taxed as ordinary income. Using the limited partnership does not eliminate the depreciation recapture it only delays it until the contributor withdraws assets from the partnership. In this Case the benefit is not claiming the entire $417,725 in one year but being able to spread it over nine years.

In summary, the timing of income can have a significant effect on tax liability. The difference in accumulated income between the worst-case (1) and best case (4) was $275,667 or 25% better. The analysis was a function of the facts and assumptions used. If the cash flows were discounted to a present value, the difference would decrease.

[Note to Phil: Do we want to add a Case where the Farmers lease the land and equipment and live off the lease payments and retirement income and then leaves everything to the children who get a stepup in basis and sell it for no tax liability?]

Each individual will have different assets with different market values and different adjusted bases. The objective of this paper was to show that the timing of the sale of those assets may affect the after-tax income available. Before retiring, a consultation with a tax professional who can look at the effect of different strategies would probably be worth the effort.