Chapter 6: Agricultural Issues and Rural Investments

The American Taxpayer Relief Act of 2012 (ATRA) makes permanent key parts of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). For example, EGTRRA expanded the individual income tax brackets, but the expansion was set to expire on a certain date, which Congress extended several times. ATRA made the expanded tax brackets permanent. ATRA also permanently increases the alternative minimum tax (AMT) exemption. These changes and other provisions of ATRA are very taxpayer-friendly.

Although some analysts had anticipated that Congress would extend the 2% rate reduction in the employee’s portion of FICA taxes, the rate reduction was allowed to expire. As a result, all wage earners and self-employed persons who are subject to FICA taxes pay a higher rate in 2013 compared to 2011 and 2012.1

In addition to not extending the FICA rate reduction, ATRA also contains significant tax increases. These increases have a significant effect on taxpayers in the higher income ranges.

Note. ATRA is discussed more fully in the 2013 University of Illinois Federal Tax Workbook, Volume A, Chapter 1: New Legislation. The discussion here highlights the parts of ATRA that are most important to taxpayers who are engaged in production agriculture or who are rural landowners.

Higher Income Tax Rate2

ATRA imposes a 39.6% rate on taxable income above the following amounts.

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>2013 Threshold</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married Filing Jointly (MFJ) or Qualified Widower (QW)</td>
<td>$450,000</td>
</tr>
<tr>
<td>Head of Household (HoH)</td>
<td>425,000</td>
</tr>
<tr>
<td>Single (S)</td>
<td>400,000</td>
</tr>
<tr>
<td>Married Filing Separately (MFS)</td>
<td>225,000</td>
</tr>
</tbody>
</table>

These thresholds are indexed for inflation for tax years beginning after 2013.

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1. The employee’s portion of FICA tax for 2013 increases from 4.2% to 6.2% and the self-employed tax rate increases from 10.4% to 12.4%. For a taxpayer with wage and/or self-employment income at or above the maximum wage base of $113,700 for 2013, an additional $2,274 in tax liability results from the rate increase.

2. IRC §1(i)(3).
For taxpayers in the top bracket in 2013, the **marriage penalty** can be significant.

**Example 1.** Tom and Gail are married. For 2013, Tom has taxable farm income of $400,000 and Gail also has wage income of $400,000 from her job as a farm business consultant for the University of Illinois. After the deduction for half of self-employment (SE) taxes, the standard deduction, and allowed exemptions, their taxable income is $775,394.

Based on the 2013 tax rates, the couple will owe income tax of $254,702 and Medicare surtaxes of $4,950.

Using the same facts, if Tom and Gail were not married, their combined income tax would be $224,142 and the Medicare surtaxes would be $3,600. Thus, the marriage penalty is an additional $30,560 in income taxes for 2013 and an additional Medicare surtax of $1,350. For Tom and Gail, the marriage penalty totals $31,910.

**Note.** The Medicare surtaxes were created as part of the Patient Protection and Affordable Care Act of 2010. The surtaxes are covered later in this chapter.

### PHASEOUTS OF PERSONAL EXEMPTIONS AND ITEMIZED DEDUCTIONS

ATRA also increases taxes for taxpayers whose adjusted gross incomes (AGI) are not above the threshold for the new 39.6% rate. ATRA does this by reinstating the phaseouts of personal exemptions and itemized deductions. The exemption phaseout begins at the following thresholds.

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>Threshold</th>
</tr>
</thead>
<tbody>
<tr>
<td>MFJ or QW</td>
<td>$300,000</td>
</tr>
<tr>
<td>HoH</td>
<td>275,000</td>
</tr>
<tr>
<td>Single</td>
<td>250,000</td>
</tr>
<tr>
<td>MFS</td>
<td>150,000</td>
</tr>
</tbody>
</table>

Once the applicable threshold is reached, the allowable deduction for exemptions drops by 2% for every $2,500 (or portion thereof) that the taxpayer’s AGI exceeds the threshold. For those filing as MFS, the reduction is 2% for every $1,250 of income above the threshold amount.

The same thresholds apply to the phaseout of itemized deductions. Once the applicable AGI threshold is reached, itemized deductions are reduced by 3% of the taxpayer’s AGI that exceeds the threshold, up to a maximum reduction of 80% of the otherwise allowable itemized deductions.

**Note.** Because the thresholds are lower for these provisions than those that apply to the beginning of the 39.6% rate, taxpayers with incomes less than the threshold for the beginning of the 39.6% rate will see an effective tax increase. The effective rate increase is 3% of the stated tax rate; thus, it is 1.188% for taxpayers in the 39.6% bracket and .99% for taxpayers in the 33% bracket.

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3. The example is courtesy of Paul Neiffer, CPA, in Spokane, Washington. Although modified slightly, it is based on an actual client situation.
4. IRC §151(d)(3). The phaseout range is $125,000 (i.e., $2,500 × 0.02) for taxpayers other than those filing MFS and $62,500 for those filing MFS. The effective tax rate increase varies, depending on the number of personal exemptions claimed. Taxpayers filing as MFJ are fully phased out before being subject to the 39.6% bracket. For example, it is 4.37% for a taxpayer claiming 4 exemptions at the 35% rate.
5. IRC §§68(b)(2). This provision is indexed for inflation for tax years that begin after 2013.
6. IRC §§68(b) and (c). The phaseout is not applicable to itemized deductions for investment interest, medical expenses, casualty or theft losses, and gambling losses.
INCOME TAXATION OF ESTATES AND TRUSTS

ATRA eliminates the 35% rate for the income of estates and trusts and replaces it with a 39.6% rate. The starting point for the new 39.6% rate is $11,950 for 2013.

**Observation.** ATRA does not clearly address how the new 39.6% ordinary income tax rate and the 20% capital gain rate apply to trusts and estates. Section 101(b)(1)(B) of ATRA adds IRC §1(i)(3), which states that the rate of tax under subsections (a), (b), (c), and (d) increases from 35% to 39.6% for income above the “applicable threshold.” Trusts and estates are not taxed under any of these subsections. Instead, they are taxed under IRC §1(e). In addition, ATRA does not provide any threshold amount at which the 39.6% bracket begins. Perhaps an argument can be made that ATRA simply reinstates the tax rates that were in effect before EGTRRA became effective, including the 39.6% rate.

Permanency of Transfer Taxes

ATRA, effective for transfers after 2012, establishes a $5 million (inflation-adjusted) unified credit exemption equivalent for estate, gift and generation-skipping transfer tax (GSTT) purposes. For 2013, the inflation-adjusted amount is $5.25 million. The present interest annual exclusion for gift tax purposes is $14,000 for 2013. Portability of the unused amount of the exclusion at the death of the first spouse to die is also retained and made permanent. However, the rate on transfers above the amount covered by the credit is increased from 35% to 40%. Specifically, under ATRA, transfers exceeding $500,000 are taxed at 37%, transfers over $750,000 are taxed at 39%, and transfers over $1 million are taxed at 40%. Thus, with the exemption equivalent of the credit set at $5.25 million for 2013, the unified credit for 2013 is $2,045,800.

**Note.** Other EGTRRA transfer tax changes were made permanent. These include the repeal of the state death tax credit (it was replaced with a deduction), the repeal of the qualifying family-owned business (QFOB) deduction, modification of the qualified conservation easement donation rules, technical changes to the installment payment rules, and certain GSTT technical amendments. Stepped-up basis is retained.

SELECTED CORPORATE TAX PROVISIONS

2-Year Extension for Excluding 100% of Gain on Certain Small Business Stock

ATRA restores for 2012 and extends through 2013 the ability to exclude all of the gain on the sale of IRC §1202 stock. The stock must have been acquired after September 27, 2010. A 5-year holding period requirement must be satisfied and the corporation must be a C corporation during the holding period. Without additional legislation, the exclusion drops to 50% beginning January 1, 2014.

5-Year Recognition Period for S Corporation Built-in Gain (BIG) Tax

For tax years beginning in 2012 and 2013, ATRA provides a 5-year recognition period instead of a 10-year period for computation of any net recognized BIG. In addition, the provision specifies that if an installment sale is made after the recognition period (e.g., five years) and the recognition period reverts to 10 years, the gain on the installment sale is protected from the BIG tax. Also, if the BIG income is carried forward to future years due to the taxable income limitations and the BIG period has expired, no BIG tax applies to the expired amount. Further, a new provision states that if an S corporation sells an asset under the installment method, the treatment of all payments received are governed by this provision applicable to the tax year in which the sale was made.

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7. With portability, the deceased spouse’s unused exemption equivalent of the unified credit (the deceased spouse’s unused exclusion amount) can be transferred by election to the surviving spouse. Form 706 must be filed for the estate of the first spouse to die, regardless of the size of the decedent’s estate, to make the election. Portability applies only to the unused exemption of the decedent’s last surviving spouse.