Consider tax consequences when gifting ag commodities to children

Contributed by **Roger McEowen**

AT A GLANCE

Commodity gifting transactions must be structured properly to achieve the intended tax benefits.

For farm parents, gifts to children may take the form of agricultural commodities. Such transfers may be done to shift income to minor children to take advantage of their lower tax rates, assist with a child's college costs or be made in exchange for the child to support the donor-parents.

The gifting of ag commodities raises several questions: How should commodity gift transactions be structured? What are the tax consequences? What is the status of current law on commodity gifts to children?

This article will provide some answers.

Tax consequences to the donor

Gifting ag commodities can help the donor avoid income and self-employment taxes. A gift of an unsold, home-raised farm commodity represents a transfer of an asset rather than an assignment of income. The donor does not recognize income upon a gift of unsold grain inventory, for example.

That means the farmer, as the donor, sidesteps the income tax on commodities transferred by gift to another taxpayer. Further, self-employment tax is also eliminated because excludable gross income is not considered in determining self-employment income. This is particularly beneficial for donor-parents that have income under the Social Security wage base threshold, which was $142,800 for 2021. The wage base for 2022 is $147,000.

The gifted commodities should have been raised or produced in a prior tax year. If this is not the case, the Internal Revenue Service (IRS) takes the position that a farmer is not 100% in the business of raising agricultural commodities for profit and will require that a pro rata share of the expenses of raising the gifted commodity will not be deductible on the farmer's tax return. According to the IRS, if a current year's crop is gifted, the donor's opening inventory must be reduced for any costs or undeducted expenses relating to the transferred property. That means the donor cannot deduct current-year costs applicable to the commodity.

However, costs deducted on prior returns are allowed. Thus, a farmer reporting on a calendar-year basis under the cash method is allowed full deductibility of expenses if a gift of raised commodity is not made until the tax year after harvest (i.e., the grain which is the subject of the gift was raised in a year prior to the gift, and all associated expenses would have been deducted in the prior year).

Tax consequences to the donee

The donor's tax basis in the commodity carries over to the donee. In the case of raised commodities given in the year after harvest by a cash-method producer, the donee receives the donor's zero basis. Conversely, an accrual-method farmer will have an income tax basis in raised commodities. If this tax basis approaches the market value of the commodity, there will be little income shifting accomplished from a gift.

Assuming the donee has not materially participated in the production of the commodity, the income from its sale by the donee is treated as unearned income that is not subject to self-employment tax. Even though the raised farm commodity was inventory in the hands of the farmer-donor, the asset will typically not have inventory status in the hands of the donee. That means the sale transaction is treated as the sale of a capital asset that is reported on Schedule D.

The holding period of an asset in the hands of a donee refers back to the holding period of the donor. So if the donee holds the commodity for more than a year after the harvest date, the donee has long-term capital gain or loss.

Gifts of livestock

A donee who receives raised animals and takes responsibility for the care and feeding of these animals after the date of gift may face the risk of materially participating in the raising of the animals – and thus be subject to self-employment tax. To help avoid that result, physical segregation of the livestock at the time of gift is helpful, and any post-gift maintenance expenses for the animals should be paid by the donees.

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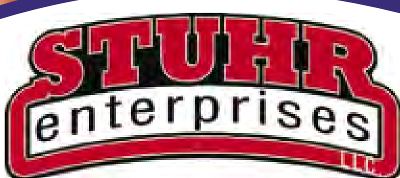

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Structuring the transaction

Cash-method farm proprietors intending to gift raised commodities to a child or other non-charitable donee should structure the transaction in two distinct steps. First, the donor makes a gift of unsold inventory, using prior-year crop or commodity, and documents the transfer of the title/ownership in the commodity as transferred to the donee. Second, the donee independently and at a later date accomplishes a sale of the commodity, recognizing income because of the zero basis in the commodity. The income is reported typically as a short-term capital gain. The donee, as the owner of the sold commodity, must retain full ownership and control of the sale proceeds from the commodity. Make sure the transaction is not a loan.

'Kiddie Tax' complications

The "Kiddie Tax" taxes a child's passive (unearned) income at the same rate of their parents to eliminate income shifting from the parent to the child. For most taxpayers, the Kiddie Tax is based on the child's taxable income. A child's taxable income is computed by taking the child's net earned income and adding to it the child's net unearned income and then subtracting the child's standard deduction.

For 2021, Kiddie Tax applies to a child who has not attained age 18 before the close of the year. It also applies to a child who has not attained the age of 19 as of the close of the year or is at least age 19 and under 24 at the close of the year and is a full-time student at an educational organization during at least five months of the year, and the child's earned income didn't exceed one-half of the child's own support for the year (excluding scholarships).

The Kiddie Tax has a small inflation-indexed exemption. For dependent children who sell commodities received as a gift and are subject to the Kiddie Tax, the child's unearned income in excess of $2,200 ($2,300 for 2022) is taxed at the parents' top tax rate (and, it might be possible for the parents to elect to include this income on the parents' return instead of filing a separate return for the child).

Under the Tax Cuts and Jobs Act (TCJA), the rate of the Kiddie Tax was tied to the rates paid by trusts and estates. However, the SECURE Act repealed the TCJA change in the Kiddie Tax and became effective for 2020 and beyond. There is also the option to apply the rules to 2019 returns and amend 2018. Thus, the fix is retroactive for 2019 and 2018 returns.

The new Kiddie Tax formula under the Secure Act is as follows: Child's net earned income + child's net unearned income – child's standard deduction = child's taxable income.

Thus, if Billie (a dependent child) had no earned income and unearned income (dividends and interest, for example) of $5,000, and Billie's parents had $170,000 of taxable income, the calculation would be:

$0 + $5,000 – $1,150 = $3,850 (taxable income).
$5,000 (unearned income) – $2,300 (Kiddie imputed exemption) = $2,700 (net unearned income)

Thus, $2,700 would be taxed. The first $2,500 would be taxed at 10%. The next $200 would be taxed at 24%.

Conclusion

Gifting commodities to a family member can produce significant tax savings for the donor and also provide assistance to the donee. However, the commodity gifting transactions must be structured properly to achieve the intended tax benefits.

Legal and tax citations have been removed from the original article posted on the Agricultural Law and Taxation Blog. Access citations here: lawprofessors.typepad.com/agriculturallaw/2021/12/gifting-ag-commodities-to-children.html

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