Farms and the New 2013 Medicare Tax Increases

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The new health care law passed by Congress in 2010 has been gradually phasing in health care reform measures each year since its enactment. Two Medicare tax increases are part of these health care reform measures that will become effective **January 1, 2013.** The two Medicare tax increases that will affect farming income for higher-income farmers are:

- A 0.9% increase in the existing Medicare tax on "earned" farming income, such as farming wages or self-employment income from farming, and
- A new 3.8% Medicare tax on "unearned" or "passive" farming income.

The 0.9% increase represents an increase on the existing Medicare tax that is part of the payroll tax applicable to farm and non-farm wages or self-employment income. The 3.8% increase is novel because this is the first time that Medicare tax will apply to "passive" types of income. These Medicare tax increases will only affect farmers in years when combined farming and non-farming income exceed:

- $200,000 (for individual filers) or
- $250,000 (for farmers filing jointly with spouses).

In addition, the Medicare tax increases will only apply to the combined amounts of farming and non-farming income that falls **above** these thresholds within the tax year. Farmers with incomes below these thresholds will not be affected.

Medicare Tax Increase of 0.9% on Earned Income

For 2012, an employee pays a Medicare tax of 1.45% on all farm and non-farm wages. Self-employed farmers pay a 2.9% Medicare tax as part of the self-employment tax paid on farm and non-farm net earnings from self-employment each year. In 2013, an additional 0.9% increase will apply to farmers with earned income in excess of the thresholds noted above.

Example: Don and Linda are married and file jointly. Don works full-time on the family farm while Linda works as a corporate executive for a major manufacturing company in the city. For 2013, Don and Linda have the following income:

Don's net farming earnings (shown on Schedule F):	$160,000
Linda's wage earnings (shown on Form W-2):	$180,000
Total 2013 joint income:	$340,000

In 2013, Don will pay Medicare tax of 2.9% on his net farming earnings as part of the self-employment tax. Linda's employer will have withheld the 1.45% Medicare tax from Linda's pay that she owes in connection with her wages (the employer pays the other 1.45% to arrive at the 2.9% total Medicare obligation for Linda's payroll tax). For 2013, Don and Linda will pay the following amount of Medicare tax.

	Don	**Linda**	**Total Medicare Tax for 2012**
Income Subject to Medicare Tax	$160,000	$180,000	
Medicare Tax Paid	x 2.9%	x 1.45%	
	$4,640	$2,610	$7,250

However, in addition to the $7,250 of Medicare tax noted above, the new 0.9% increase in Medicare tax that applies to earnings becomes effective January 1, 2013 so Don and Linda will pay the following increase in the Medicare tax in 2013 (that did not apply in 2012).

Additional Medicare Tax in 2013

Don's Income	$160,000
Linda's Income	$180,000
Total Joint Income	$340,000
Less: Joint filer threshold for new medicare tax	($250,000)
Amount of joint income over threshold	$90,000
	x0.9%
Additional 0.9% Medicare tax due in 2013:	$810

Accordingly, for 2013, Don and Linda will pay $8,060 in Medicare tax ($7,250 + $810).

Medicare Tax Increase of 3.8% on Passive Farming Income

The new 3.8% Medicare tax on unearned income makes a distinction between "active" income from a farming trade or business (to which the new tax will not apply) and "passive" income (which will trigger the tax for farmers with income over the $200,000 or joint $250,000 income threshold previously noted).

"Passive income" for purposes of the new Medicare tax is defined as:

Interest, dividends, rents and royalties from passive activities

Net capital gains from the sale of property or assets, including farm assets, of a passive activity.

Income, including income from farming, is considered active income from a farming trade or business if the farmer materially participates in the farming activity. Under the Tax Code, there are several material participation tests[1]. The farmer materially participates in the farming activity for a particular tax year if:

1. More than 500 hours are spent participating in the farming activity for that year
2. The farmer's participation in the farming activity represented substantially all of the total participation of all persons who participated
3. The farmer participated more than 100 hours and more than anyone else in the activity for the year
4. The farmer participated on a regular and continual basis during the year based on all the facts and circumstances.

While the above four tests are perhaps the easiest ones for a typical farmer to meet, other tests exist that can be met. The material participation must be applied for each separate taxation year[2] and the participation of a farmer's spouse will count as participation of the farmer.[3] Farmers that do not perform physical labor on a farm but have self-employment income from the management of the farm are generally considered to materially participate as long as the farmer is regularly and continuously making independent management-type decisions for the farm's operations. Examples of this include decisions regarding:

Crop rotation

Expenses for animal breeding

The breeding and mating of animals

The purchase or sale of animals, machinery or equipment, or

Selecting and providing direction to a crop or herd manager.[4]

Meeting the material participation requirement for farming or other activity means income from that activity will not be subject to the 3.8% Medicare tax, but the higher-income farmer over the income threshold will still pay the smaller 0.9% Medicare tax increase on wages or earnings for the year in excess of the threshold amounts mentioned earlier.

Selling Farm Property

The 3.8% Medicare increase applies to net gains from the sale of property or assets of a passive activity. Whether the new tax applies to the sale of farmland and other farm assets depends on whether the farmer materially participates in that farming activity.

Example: Samantha has owned her farm since 2001. After purchasing the farmland, she built a barn and bought a tractor. In 2013, she sold the farm. The sale included the farmland, barn and tractor. The following amounts are relevant to the transaction.

	Farmland	Barn	Tractor
Original cost	$400,000	$100,000	$50,000
Depreciation claimed		$70,000	$50,000
Adjusted basis	$400,000	$30,000	
Sale price	$700,000	$80,000	$15,000
Realized gain or loss (sale price - adjusted basis)	$300,000	$50,000	$15,000
Depreciation recapture on assets		$15,000	$15,000

The total amount of capital gain and depreciation recapture is **$365,000** ($300,000 + $50,000 + $15,000). Samantha did not materially participate in the farming activity for 2013. She worked full-time as a stockbroker. In addition to paying capital gains tax on the $300,000 gain on the sale of the farmland, she will also pay the 3.8% Medicare tax on some or all of that capital gain and on the depreciation recapture amount on the assets sold. The total amount of Medicare tax she will pay on the transaction depends upon her income from other sources and how much income she has over the $200,000 threshold for a single filer that applies once her other income and the income from the farm sale are reported. If Samantha has $200,000 or more income from her stockbroker position, the 3.8% Medicare tax will apply to the entire capital gain and depreciation recapture amount. Her total amount of the new Medicare tax will be **$13,870** (3.8% X $365,000). If she has under $200,000 of income from other sources, only part of the farm sale transaction (that amount in excess of $200,000 of income) will be subject to the new 3.8% Medicare tax.

If Samantha met one of the several tests for material participation in the farming business, the 3.8% Medicare tax will not apply to the farm sale transaction. This is because the farm was characterized as an active farm trade or business instead of a passive activity in which the farmer does not materially participate. Note that the Medicare tax applies to the capital gain on the transaction, not the gross proceeds.

Retired Farmers and Surviving Spouses

Retired farmers and their surviving spouses selling farm property have the benefit of some special rules that may allow them to meet the "material participation" requirement even though they may not be currently active in farming the property. These special rules may give them the ability to sell the farm without paying the 3.8% Medicare tax on the gain. A retired farmer is considered to materially participate in a farming activity if the retired farmer:

- Is continually receiving Social Security benefits or is disabled, and
- Materially participated in the farming activity or another active non-farm business on the property for at least 5 of the last 8 years.

The retired farmer must have materially participated during a time when the farm was owned either by the retired farmer or a member of the retired farmer's family.[5] In addition, the required 5-year period of material participation does not need to be continuous, but can be smaller amounts of time within the 8-year "look-back" period that add up to a total of at least 5 years.[6]

In addition, a surviving spouse who inherits an active farm will be deemed to materially participate in the farming activity, even if the surviving spouse is not actually active in the business operations of the farm.[7]

Notes

1. Treas. Reg. §1.469-5T(a).

2. Ibid.

3. Treas. Reg. §1.469-5T(f)(3).

4. Tax Reform Act of 1986, H.R. Conf. Rep. No. 99-841.

5. Treas. Reg. §1.469-5T(h)(2), referencing IRC §2032A(b)(4) and (5).

6. IRC §2032A(b)(1)(C).

7. IRC §2032A(b)(5).