



Tax Issues for Estate Planning

Prepared By:

Gary A. Hachfeld, David B. Bau, C. Robert Holcomb, & James N. Kurtz, Extension Educators

Introduction:

Some of the most costly mistakes in estate planning occur when income tax aspects are ignored. A good estate plan encompasses your personal wishes and goals; accomplishes good legal, estate tax, and financial outcomes; and accomplishes positive income tax results as well. Following are the major income tax provisions to examine as you plan your estate.

Income Tax Basis:

When selling an asset, you pay tax on the difference between the selling price and adjusted basis (original cost plus improvements minus depreciation) of the asset.

-Example: If you sell land for \$100,000 and your adjusted basis (cost) for the land is \$20,000, your taxable gain is \$80,000.

Basis is your cost to recover when you sell an asset. The basis is determined by how you acquired the asset.

If You Purchased the Asset:

Your basis is what you paid for the asset plus improvements minus any depreciation you have claimed on it.

-Example: If you purchased a rental house for \$50,000 and depreciated it for three years claiming a total of \$5,000 depreciation, your adjusted basis would be \$45,000.

If You Inherited the Asset:

Your basis is the Fair Market Value (FMV) or special use value assigned the asset as it passed through the estate.

-Example: You inherit land from your mother that is valued in her estate at \$160,000. Her basis is \$40,000. Your adjusted basis is \$160,000. If you sell it for \$160,000 you have no capital gain tax consequences.

If You Received the Asset as a Gift:

Your basis is the same as the donor's basis.

-Example: You received a gift of XYZ stock valued at \$120,000 but having a basis (donor's purchase price) of \$25,000. Your basis is also \$25,000. If you sell it for \$120,000, you have a \$95,000 taxable capital gain.

Note: it is good practice to file gift tax Form 709 even though no gift tax is due. This process constitutes "adequate disclosure" and can eliminate future gift tax issues.

Basis is extremely important to property holders because it determines the amount of income tax they will pay on the sale of an asset. Assets that are inherited and pass through an estate receive a new or "stepped up" basis. The stepped up basis is usually the FMV on the date of death. This provides a strong incentive to hold low basis property until death to achieve the stepped up valuation for heirs.

-Example: Sally Smith sold 160 acres of farmland for \$2,500 per acre or \$400,000. It had a basis of \$100,000. Her taxable gain (whether sold for cash or by installment method) is \$300,000. Because of the sale, either she or her heirs must pay tax on the \$300,000 gain. Capital gain taxes at an approximate 22% tax rate (federal-15%, MN-7%) would be \$66,000. If, however, Sally retained the property until her death, the estate would assign a stepped up basis of \$400,000 (FMV). The heirs could then sell the property for that amount and pay no tax. Total taxes saved by keeping the property until death and passing it through the estate would be \$66,000.

Installment Sales:

Many people report sales of property on the installment method. This allows the taxation to be spread out proportionally during the years that principal payments are made. This option may be useful to keep as many dollars in the lower tax brackets as possible. Using installment reporting late in life on low basis assets may not be wise because no stepped up basis is received on installment contracts. Heirs inheriting the contract must continue to pay income taxes on the principal and interest payments as they receive them.

-Example: You own 40 acres of land worth \$100,000. You have a basis (purchase cost) of \$10,000 in the land. At age 85 you sell the land to your son for \$100,000 on an installment contract payable over 20 years.

Your profit ratio on the amount of each principal payment, which is taxable, is 90% (\$90,000 profit ÷ \$100,000 sale price = 90%). You receive principal payments of \$5,000 each year for 4 years. Each year you include 90% of \$5,000 or \$4,500 as taxable income on your tax return plus any interest received. At age 89 you die, leaving the contract equally to your two daughters and son. Your two daughters will continue to receive 2/3 of the \$5,000 annually and must include 90% of the amount on their tax return for the remaining 16 years. They will each receive \$26,667 in principal payments and will have to pay income taxes on \$24,000 of it (90%). The son, who holds the contract, inherits the entire \$26,667 in the year of death. The 90% or \$24,000 is taxable income to him in the year of your death.

If you and your children together must pay taxes at a capital gain rate of approximately 22% (federal-15%, Mn-7%), approximately \$19,800 of tax will be paid on this contract over the years. If you had kept the property in your estate and not sold it, it would have passed to your children valued at \$100,000 (stepped up basis) and they would owe no tax if they sold the property for that value.

Personal Residence:

If you sell your farm, which includes your personal residence, consider parceling out the house sale because it qualifies for a possible exemption from tax.

For sales after May 5, 1997, homeowners can exclude from gross income up to \$250,000 per individual of gain (\$500,000 for joint filers). You must have owned your home and lived in it for a period of two of the past five years prior to the sale. You need not buy a replacement home to qualify for this tax exemption.

These provisions apply to the house only, not to land or buildings used as business property.

Tax Free Exchange:

Selling property outright will cause a taxable event. If you have improved land or buildings, a like-kind tax free exchange, known as an IRS Section 1031 exchange, might be considered. You find a person who has property that is "like-kind" to yours and work out a trade. Your tax basis follows to the new property. It is a complicated tax process, but can position the younger generation on the home farm. Using the tax-free exchange can avoid or postpone taxation of the parent's capital gains on low basis property. There are strict timelines involved so seek legal assistance.

Income Averaging:

Qualifying farmers are currently allowed to use "income averaging". This provision allows high income from a current year to be carried back equally to utilize lower tax

brackets from the three previous years. This provision can help reduce income taxes for retiring farmers.

Spread Out Income:

In most cases, as a farmer retires and they sell off their farm business assets, a large self-employment and income tax bill may emerge depending upon the type of asset. It may be wise to plan ahead and spread the final sales over a two or three year period. Leveling out income usually results in lower taxes paid than does bunching income into one year.

Capital Gains:

In 2003, Federal Capital Gain tax rates were lowered to 5% for individuals in the 10 & 20 % federal tax brackets and 15% for individuals in the 25% and greater federal tax bracket. Current federal law, for years 2008-2010, allows taxpayers to pay federal capital gain tax at a 0% or 15% rate depending on income level on many long-term capital gain items. Those items include stocks, bonds, and land held longer than one year, as well as some raised breeding stock. Farm building sales are generally subject to different tax rates. Keep in mind that the 0% capital gain tax rate applies **only** to the amount of gain between your taxable income and the top of the 15% federal income tax bracket (\$67,900 for 2009). Gain amounts over the top of the 15% income tax bracket will be taxed at the 15% rate. State taxes, if applicable, must also be paid on capital gains. Care should be taken when planning a transfer to maximize use of the lower tax rates available on capital assets. Sales of capital assets are not subject to self-employment tax. Consult with your accountant and attorney for the best strategy for minimizing the tax consequence of any transaction.

In Minnesota, capital gains are taxed at ordinary income rates of 5.35 – 7.85%.

Tax Code Complexity:

Each provision of the tax code listed above is very complex. When planning your estate and farm business transfer, seek good tax and legal advice. Bad decisions can be costly.

Copyright 2009. Regents of the University of Minnesota. All rights reserved.

Caution: This publication is offered as educational information. It does **not** offer legal advice. If you have questions on this information, contact an attorney.

The University of Minnesota, including Minnesota Extension, is an equal opportunity educator and employer