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Major Tax Considerations When Transferring Assets

Transferring the Farm Series: #3

Erlin J. Weness

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Income Tax Basis

When selling an asset, you pay tax on the difference between the selling price and the income tax basis of the asset

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

Income tax 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 minus any depreciation you have claimed on it.

Example: If you purchased a tractor for \$20,000 and depreciated it for three years claiming a total of \$7,000 depreciation, your basis would be \$13,000. If you purchased land and have claimed no depreciation on it, your basis would be what you paid for the land.

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 inherited some land from your mother that was valued in her estate at \$160,000. Your tax base is \$160,000.

If You Received the Asset as a Gift

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

Example: You received a gift of farm land valued at \$160,000 but having a basis (donor's purchase price) of \$25,000. Your basis is also \$25,000.

Basis of assets is extremely important to property holders because it determines the amount of income tax they will pay on the sale of the asset.

Assets which pass through an estate receive a new "stepped up" basis. The stepped up basis is usually the fair market value 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 300 acres of farm land for \$1,500/acre or \$450,000. It had a tax basis of \$100,000. Her taxable gain (whether sold for cash or by installment method) is \$350,000. Because of the sale, either she or her heirs must pay income tax on the \$350,000. If, however, Sally retained the property until her death, the estate would assign a stepped up basis of (FMV) \$450,000. The heirs could later sell the property for that amount and pay no income tax.

House

If you sell your farm, which includes your personal residence, parcel out the house sale because it qualifies for two possible provisions:

- You can postpone the gain on your house by reinvesting in a different house of greater cost within two years of the sale.
- After age 55, you can (once in a lifetime) exclude up to \$125,000 of gain on your personal residence from any income taxation. You would normally use this provision when you move out of your last home to a rental unit or rest home.

These provisions apply to the house only, not to the entire farm or even to the farm buildings.

Homestead Credit

Qualifying owners who live on the farm can receive a reduced tax due to the Minnesota Homestead Tax Laws. This credit can reduce real estate taxes substantially each year. Structure transfer plans to make the best use of this credit.

Farm owners who have relatives living on their farm may qualify for a double homestead credit—one on their personal residence plus a second on a one-acre portion of the farm if a relative lives there.

If you sell your home, but retain a life estate, you are disqualified from using the over-55 exclusion,

but you can maintain the Minnesota Homestead Credit.

Installment Sales

Many farmers 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 must continue to pay the income taxes on principal and interest payments as received. Most items can be sold using the installment method. One major exemption is machinery and equipment and all other Section 1245 property. Gain to the extent of depreciation claimed must be reported the year of sale and is not eligible for installment reporting.

Tax-Free Exchange

If the younger generation owns tradable property, a like-kind tax free exchange might be used to transfer farmland or buildings. This is a complicated tax move, but can move the younger generation onto the home farm and leave the older generation with more remote, low maintenance farm land. Using the tax-free exchange can avoid or postpone taxation of the parents' capital gains on low basis property.

Spread Out Income

In most cases, as a farmer retires and sells off his or her assets, a large income and self employment tax bill emerges. It may be wise to plan ahead and spread the final sales over a two- or three-year period. Leveling income usually results in lower taxes paid than bunching income into one year.

Tax Code Complexity

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

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

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Erlin J. Weness
Area Extension Educator
Farm Management

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