



UNIVERSITY OF MINNESOTA
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Ag Business Management

Informing farm families and ag businesses about management issues.

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Tax Considerations When Transferring Assets

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Income Tax Basis:

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

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

Adjusted basis is your cost to recover when you sell the asset. This adjusted basis is determined by how you acquired the asset.

If you purchased the asset:

Generally, your basis is what you paid for the asset, plus improvements, minus any depreciation you've claimed on it.

Examples:

- 1) If you purchase a tractor for \$120,000 and depreciated it for 3 years claiming a total of \$42,850 depreciation, your adjusted basis would be \$77,150 (assuming no improvements).
- 2) If you purchased land and have claimed no depreciation on it, your basis is what you paid for it, plus any improvements.

If you inherited an asset:

Your basis is the Fair Market Value (FMV) or Special Use Value assigned the asset as it passed through the estate to you.

Example: You inherited some land from your mother. Her adjusted basis was \$70,000. Upon her death, the land received a step up in basis and is valued in her estate at \$160,000. Your adjusted or cost basis is \$160,000.

If you received an asset as a gift:

Generally, your basis is the same as the adjusted basis of the donor.

Example: You received a gift of farmland valued at \$160,000 with a basis (purchase price) to the donor of \$25,000. Your basis is then \$25,000.

Asset basis is extremely important to the property holder since it determines the amount of tax that will be paid upon the sale of the asset.

Assets that pass through an estate receive a "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 160 acres of farmland for \$3500/acre or \$560,000. It had an adjusted basis of \$100,000. Her taxable gain whether sold for cash or by installment method would be \$460,000. Because of the sale, she or her heirs must pay income tax on the \$460,000 gain. However, if Sally had retained the property until her death, the estate would assign a stepped up basis to FMV of \$560,000. The heirs could later sell the property for that amount and pay no tax.

Personal residence:

If you sell your farm, which includes your personal residence, up to \$250,000 per individual (\$500,000 for married filing jointly) of the gain on the residence portion may be excluded from taxation. To qualify for the full exclusion, you must have owned and occupied the residence for at least two out of the five years before the sale. Property held under 2 years may qualify for a partial exclusion under certain conditions.

Homestead Credit:

Qualifying owners, who live on the farm, or in the house on the farm, can receive reduced real estate tax payments due to the Minnesota Homestead Tax Laws. This credit can reduce real estate taxes substantially each year. Structure your 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. They receive one credit on their personal residence and a second credit on the farm, if a relative lives on the farm or farms the land.

If you sell your home but retain a life estate, you may be disqualified from using the personal residence exclusion. You can still maintain the Minnesota Homestead Credit. See your attorney.

Installment Sales:

Many farmers opt to report sales of property on the installment method. This allows the taxation to be spread out proportionally over 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 since no stepped up basis is received on installment contracts. Heirs must continue to pay the income taxes on principal and interest payments when received. Most items can be sold using the installment method. Any gain, to the extent of depreciation on equipment and all other Sec. 1245 property as well as depreciable business property sold to related parties, will not qualify for installment tax treatment. The installment sale does not protect the asset from lawsuits and other adverse actions.

Tax Free 1031 Exchange:

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

Caution: make sure your attorney and accountant communicate regarding this type of transaction so no detail is overlooked. Failure to comply with all the stipulations of the exchange can result in forfeiture of the transaction and tax consequences.

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 compared to bunching income into one year.

Capital Gains:

In 2003, Federal Capital Gain tax rates were lowered to 5% for those in the 10 & 20 % federal tax brackets and 15% for those in the 25% and greater federal tax bracket. Current federal law, for years 2008-2010, allows taxpayers to pay 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 (is \$67,900 for 2009). Gain amounts over the top of the 15% income tax bracket will be taxed at the 15% rate. State taxes must also be paid on capital gains (MN rates are 5.35-7.85%). 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.

Income Averaging:

Income averaging allows farmers to spread their income in a high income year over the past three years. This can significantly reduce taxes paid in a high-income year. Income averaging does not affect self-employment tax on either the current or previous years. Income averaging applies to ordinary (Schedule F, Form 1040) farm income as well as gain from the sale of assets used in the farming business except from the sale of land or timber. It also applies to an owner's share of net farm income from an S corporation, partnership, or limited liability company and wages received by an S corporation shareholder from the S corporation.

Self-Employment (SE) Tax:

If you have contributed to the SS system at a high level during your lifetime, you may be considering retirement before your Full Retirement Age (FRA) to begin drawing SS benefits. This would result in a reduced monthly benefit compared to retiring at your FRA. However, it might take many years of higher benefits to offset drawing reduced benefits for several additional years. In addition, farmland rental income is not subject to SS taxes. Not retiring early could cost you more per year due to not collecting monthly benefits and having to pay added tax on SE income.

However, if you have contributed to SS on a low level of earnings during your lifetime, it may be advantageous to delay retiring until your FRA. Hopefully during these last few years you can build your benefit package by making larger contributions to SS. High earnings and high contributions could have a significantly positive effect on your Social Security benefits.

This is a complicated issue but also a crucial issue to you and your farm business transfer and retirement planning. Seek advice from a qualified Social Security representative.

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