Estate Planning Series #7

INCOME TAX ISSUES FOR ESTATE PLANNING

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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 the income tax basis (original cost) 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 rental house for $50,000 and depreciated it for three years claiming a total of $5,000 depreciation, your 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 inherited some land from your mother that was valued in her estate at $160,000. Your tax basis is $160,000. If you sell it for $160,000 you have no capital gains tax.

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 $160,000 but having a basis (donor's purchase price), $25,000. Your basis is also $25,000. If you sell it for $160,000, you have a $135,000 taxable capital gain.

Asset basis is extremely important to property holders because it determines the amount of income tax they will pay on the sale of the asset. Assets that are inherited and 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 farmland for $1,500 per 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. Capital gain taxes at a 15% tax rate would be $52,500. If, however, Sally retained the property until her death, the estate would assign a stepped up basis of $450,000 (FMV). The heirs could later sell the property for that amount and pay no income tax. Total income taxes saved by keeping the property until death and passing it through the estate would be $52,500.

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 must continue to pay the income taxes on principal and interest payments as they receive them.

Example: You own 100 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 $4500 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 $5000 annually and must include 90% of the amount on their tax return for the remaining 16 years. They will each receive $26,666 in principal payments and will have to pay income taxes on $23,999 of it (90%). The son who holds the contract, inherits the entire $26,666 in the year of death. The 90% or $23,999 is taxable income to him in the year of your death.

If you and your children must pay taxes at a capital gain rate of 15%, a total of $13,500 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 income taxes if they sold the property for that value.

Selling on an installment sale late in life, cost this family $13,500 in unnecessary income taxes.

House:
If you sell your farm, which includes your personal residence, parcel 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 of gain ($500,000 for joint filers). You must have owned your home and lived in it for a period of two of the prior five years before the sale. You need not buy a replacement home to qualify for this tax exemption.

If you sold your home prior to May 6, 1997, different, more restrictive rules apply.

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 a 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 and leave the older generation with more remote, low maintenance farmland. Using the tax-free exchange can avoid or postpone taxation of the parent’s capital gains on low basis property.

Income Averaging:
Beginning Jan. 1, 1998, qualifying farmers are 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 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 out income usually results in lower taxes paid than does bunching income into one year.

Capital Gains:
Capital assets held over 12 months generally qualify for lower tax rates. For sales after May 5, 2003, federal capital gains tax rates are 5% for taxable incomes under about $56,800(MFJ) and 15% for taxable incomes over $56,800(MFJ). Minnesota adds a 5.35-7.85% tax on capital gains. Overall capital gains rates are from 5 to 20% less than tax rates on ordinary income.

Tax Code Complexity:
Each provision of the tax code listed above is very complex. When planning your estate 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.