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Reviewed: July 2000

INTERGENERATIONAL TRANSFER TAXATION

Parman R. Green
UO&E Farm Business Management Specialist

For many farm families, the continuation of the family farm business is one of their goals. However, most families will have a number of goals and objectives, and it will be necessary for the family to establish a priority listing. Estate planning is somewhat like putting a puzzle together, so that the individual pieces fit and best meet the overall needs. This article discusses intergenerational asset transfers.

Income, gift and estate taxes are major issues which must be analyzed when considering intergenerational asset transfers. In general, our current tax laws encourage the passing of assets from one generation to the next via the estate. However, many farm families find themselves in situations where they would like to make life-time transfers, either by sale or gift, to the succeeding generations. Because the farming business is so difficult to enter without family assistance, the issue of intergenerational transactions is a very important consideration for most farm families.

Intergenerational transfers should be made only after gaining an understanding of the relevant tax provisions or after consulting with your tax advisor. Two issues of particular concern are: 1) installment sales of depreciable assets and 2) assets with a low tax basis relative to fair market value. The tax treatment of these types of transactions varies substantially with regard to income, gift and estate taxes.

The installment tax trap is the item that catches too many farmers. The sale of depreciable property requires the recapture of depreciation (including Section 179 expensing) as ordinary income up to the amount of gain. The trap involving the installment sale of depreciable assets is that the total recapture as ordinary income must be reported and recognized in the year of sale, regardless of the amount of money received in the year of sale. Thus, if you sell on installment contract a line of machinery that is depreciated out, you will likely have to report the entire gain as ordinary income in the year of sale, even though you will receive the money from the sale over a number of years. This trap can create a severe short-term cash flow problem for the seller.

The other tax issues which complicate life-time transfers of assets from one generation to the next are the different treatment of basis and the forgiveness of gain for income tax on property which passes through an estate. We are all too familiar with the income tax consequences of selling an asset during life, we pay income tax on the difference between the selling price and the tax basis. However, if we let that same asset go through our estate, our heirs will receive a step-up in basis to the fair market value and the income tax on the accumulated gain to date of death is forgiven. On the other hand, if we transfer the asset during life via a gift, we avoid the income tax consequences, but our heirs receive our tax basis and will suffer the income tax consequences if they dispose of the property in a taxable transaction.

There is no one best way to handle intergenerational transfers as each situation is unique. However, hopefully this article has shown the need for planning before action.
