



# Bulletin

Extension

---

## Estate Planning Considerations for Ohio Families

### Section 7

---

## Income Tax Considerations

by Jim Polson and David Miller\*

Income tax considerations are a crucial part of estate planning, especially for persons with businesses or large estates. Basic income tax provisions with implications for estate planning are discussed here.

### Understanding “Tax Basis” is Crucial

“Income tax basis” is a crucial tax concept that is important when considering income, gift or estate taxes. And, in estate planning you must consider all three taxes, as well as other costs. The adjusted cost basis of the property in the hands of the owner is an important consideration that affects if, when, and how much tax is paid.

### Adjusted Cost Basis

Adjusted cost basis is the original cost of property, plus improvements, minus depreciation. In the case of inherited property, the cost basis to the recipient is generally the value in the estate, or other value as determined under federal tax law. Table 1 presents a brief outline of the adjusted cost basis and type of taxes associated with methods of transfer of property.

---

**Table 1. Taxes Associated with Three Methods of Property Transfer and Basis upon Which Tax is Figured**

Transfer Made by	What Taxes May Apply			Tax is Figured On	What Basis May Apply	
	Income	Gift	Estate		Original Owner	New Owner
Sale	X	X <sup>1</sup>	X <sup>2,3</sup>	Difference between basis and selling price (income tax)	Adjusted cost basis <sup>4</sup>	Purchase price
Gift		X	X <sup>2</sup>	Fair Market Value (FMV) at time gift is made (gift tax)	Adjusted cost basis	Same as the donor's (original owner) cost basis plus a portion of gift and estate tax paid
Inheritance—Personal, Grain <sup>5</sup> , etc.	X		X	FMV (estate tax and income tax)	Adjusted cost basis	No step-up in basis for income tax. Considered to be income with respect of the decedent.
Inheritance—Real—Other personal			X	FMV or Use Value (estate tax)	Adjusted cost basis	FMV @ death, or use value

<sup>1</sup> If sold at less than fair market value, a gift has been made.  
<sup>2</sup> Taxable gifts become part of the gross estate.  
<sup>3</sup> Balance due on an installment sale becomes part of the gross estate  
<sup>4</sup> Adjusted cost basis, which is original cost plus any new investments less depreciation allowed or allowable to date.  
<sup>5</sup> Grain gets a step-up in basis if the estate is for a farmer materially participating in the business at death.

If property is transferred by sale, income tax is usually payable by the seller on the difference between the sale price and the property's adjusted cost basis. The new owner's basis will be the purchase price. If the sale price is less than fair market value, then the seller has made a gift and gift taxes may be due presently, at the time the seller's estate is settled or not at all.

Usually, the income tax basis of an asset is what you paid for it. As a rule, when you sell business property, the difference between the selling price and the property's "income tax basis" is fully taxable. The income tax problem occurs when farm property owners have an income tax basis well below what the farm property is worth and the owners want to transfer it.

**A Farm Sale Example**

For example, if the owners paid \$20,000 for an unimproved farm when they bought it, their initial income tax basis was \$20,000. If they have never made any improvements or taken any depreciation on improvements, their income tax basis is still \$20,000. If they sell the land for its \$100,000 fair market value, they have an \$80,000 taxable gain (sales price minus basis equals gain). It is capital gain, but it is taxable.

In the example above, the initial basis is the \$20,000 originally paid for the unimproved farm. "Income tax basis" increases when you make capital improvements, and decreases when you claim depreciation. If our hypothetical farm family made capital improvements on the farm costing \$10,000, their income tax basis

would increase from \$20,000 to \$30,000. Their income tax basis would decrease each year, by the amount of any depreciation claimed on the capital improvements.

If someone gives you property, you get their adjusted cost basis too. Thus, the new owner's basis is the same as the original owner's basis plus any gift taxes paid related to the property. For example, assume that due to inflation, the farm with the \$20,000 basis has a current fair market value of \$100,000. If someone gives it to you, their gift is valued at \$100,000, but your basis would be \$20,000 plus any gift taxes paid. Thus, if you later sold it for \$100,000 you would have an \$80,000 gain, the same gain the person who gave it to you would have had if they sold it for \$100,000.

Real property transferred by inheritance may be subject to state and federal estate taxes, based on fair market value at death or an elective "use valuation." The new owner's cost basis is the fair market value in the estate or, if elected, the lower use valuation as determined under federal tax law.

## **Capital Gains Rates**

The tax rates that apply to a net capital gain are generally lower than the tax rates that apply to other income. These lower rates are called the maximum capital gain rates. For those in the 10% and 15% tax brackets, the basic tax rate on long-term capital gains is 5%. Those in higher tax brackets pay tax at a 15% rate. The 5% rate on capital gains is scheduled to go to 0% in 2008. Special 25% capital gains rates apply to gain due to depreciation on depreciable real property such as buildings.

The general holding period to qualify for capital gains is more than 1 year. The holding period for dairy and breeding cattle and horses is 24 months and 12 months for breeding hogs and sheep.

## **"Stepped-Up" Basis at Death**

Property that goes through an estate gets a "stepped-up income tax basis" equal to its appraised value in the estate. In our example, if the farm owner(s) let it pass through their estates and it is appraised in the estate(s) at \$100,000, the \$100,000 appraised value becomes the heirs' income tax basis.

However, "income in respect of decedent" does not get a stepped-up basis. This is income that is so close to being earned at death that it retains its taxable character. Most of it falls into one of three classes:

1. If the decedent was a non-materially participating landlord who rented on a share basis, the crop share and livestock share rents received do not get a stepped-up basis and are taxable when sold.
2. Accrued, but untaxed interest on U.S. Government Savings Bonds, Series E, is income in respect of decedent.
3. Payments received on installment sales contracts are income in respect of decedent.

Persons who have any of those kinds of assets need to consider them in their planning.

Under recent legislation, property that passes through an estate after December 31, 2009, will not get a "stepped-up basis." The decedent's old income tax basis will carry over to the heirs with some basis adjustment. One can expect many changes in tax laws between now and 2010.

Currently, if the parents in our example leave the farm to their children they avoid the income tax on a sale, the children receive a "stepped-up" basis equal to the property's appraised value in the estate, and the parents get the benefits of ownership until death. Potential income taxes on a sale can prove to be a significant disincentive to selling the farm.

Parents can also avoid the income tax on a sale by giving property to the children. But they must give up the benefits of ownership to have a completed gift. As a result of the gift, the children also receive the parent's \$20,000 income tax basis. The low basis means the children must pay tax on \$80,000 of gain if they sell it for \$100,000.

## **Selling Farm Real Estate to Children**

From strictly a tax standpoint, under current law it is frequently much less expensive for children to inherit property through their parents' estates rather than receiving it by gift or sale from the parents. This is primarily so when one or more of the following is true:

- the property has a low income tax basis relative to its fair market value,
- it is likely to be sold later by the person(s) who receive it,
- it may appreciate significantly in value before the death of the current owners,
- the parents have a short life expectancy, and
- the parents have a combined net worth less than \$2 million.

Paying income taxes discourages many farm families from selling the family farm to the next generation. While there is nothing in the law that specifically prohibits a sale, it is just that several key income tax, gift tax, and estate tax provisions, when considered together, may make other alternatives look better than a sale. However, there are some other considerations besides taxes that the older generation should take into account before they decide not to sell the farm to their child(ren).

## **Some Additional Considerations When Considering a Sale or Gift**

Here are some additional considerations when the situation seems to favor the transfer of at least part of the land and buildings by sale or gift while the older generation is living.

1. Responsibility for and concern about maintenance and replacement of buildings and facilities can be transferred to the younger generation.
2. The younger generation gains an opportunity to build equity and take income tax deductions for interest and depreciation. If the transfer is by purchase, they get a new basis for depreciation. They can make needed improvements and gain the benefit from their use.
3. The operating generation may be bringing a third generation into the business, and they may need the security of a base of operations which is not subject to the whim of parents or other heirs.
4. Where several parcels of land are involved, and especially where they are separate or separable, one or more could be transferred, while other(s) are retained for the older generations' security. Long-term leases, options, etc., could be used with the retained parcel(s).
5. "Low basis is better than no basis." In the case of land that is transferred by gift, the biggest disadvantage is the increased gain on the property's sale, which may never occur, or not until some distant time. The next generation may be more concerned about having control and ownership of the land than any possible future income tax consequences.
6. Sales and gifts could be used together. The parents could sell on installments, then choose each year how much principal (and/or interest) they can afford to (and want to) give back. Other uses for the funds could include paying income taxes on the sale, supplementing retirement income, or making gifts to other children. A combination of below-market sale price and/or interest rate, along with an extended-term loan, could be used to bring principal and interest payments close to cash rental rates.
7. Parents could sell a bare parcel with a higher basis to children, then make a tax-free trade of the parcel with the buildings in exchange for it.

A balance should be maintained among concerns for the parents' financial security, the children's economic opportunity, and potential income taxes.

## Sale of the Personal Residence

Sale of a personal residence, alone or as part of a farm sale, offers some unique opportunities for postponing or avoiding income taxes. Residences receive special income tax treatment even when they are sold as part of a farm or other business.

People selling farms usually are selling many different assets. Some assets qualify for special tax treatments by the seller or the buyer. It is desirable for the buyer and seller to agree on the value of assets such as fence, tile, buildings, wells, rental homes, personal residence, land, machinery, etc. If values are not in the sales contract then the parties must estimate their own.

A taxpayer can exclude from income up to \$250,000 of gain (\$500,000 for joint filers meeting certain conditions) from the sale of a home owned and used by the taxpayer as a principal residence for at least 2 of the 5 years before sale. Gone are the provisions that you must reinvest the proceeds in a more expensive house or be 55 years old or older.

Given the opportunity to not pay tax on the residence, the seller usually wants to place as much of the value as possible on the personal residence in an attempt to get the most tax benefit. Buyers usually want to set a high value on the farm buildings and other depreciable assets so they can take more depreciation.

Buyers and sellers trying to set values after the sale usually use property tax appraisals to help estimate values. For example, if the property tax appraisal attributed 20% of a property's value to the personal residence, the seller might attribute 20% of the sales price to the personal residence.

One frequent question is, "How much land can we include with the residence?" There isn't a specific number of acres. Usually it is the area surrounding the house that is fenced in or mowed for personal use.

## Sale of Machinery and Equipment

A sale of farm machinery and equipment may cause unexpected tax consequences. The general rule is that the difference between the selling price and the property's "income tax basis" is fully taxable. However, there are some additional rules that are probably best illustrated with a simple example:

Machinery Cost	\$30,000
– Depreciation	<u>– 20,000</u>
= Adjusted Basis	\$ 10,000

This farmer bought a machine for \$30,000. She has taken \$20,000 in depreciation, leaving an adjusted basis of \$10,000. Further assume that the current "fair market value" of this machinery is \$22,000.

## Unexpected Gift

If this farmer sells this machine for \$10,000 to a related party, there is no taxable gain because the sales price and adjusted cost basis are equal. However, there is a gift of \$12,000 because the fair market value

of the tractor is \$22,000. If the farmer sold the tractor to her son, the result is a \$12,000 gift to her son, and the farmer must file an IRS gift tax return reporting the gift. There is no gift tax unless the farmer has already used her applicable exclusion amount, but the farmer must file Form 709. If the farmer gave it to two people, such as her daughter and son-in-law, each received \$6,000, and no gift tax return is required.

### **Gain Taxed in Year of Sale**

If the farmer sells the machine for \$22,000, there is a \$12,000 gain (sales price \$22,000 minus \$10,000 basis). The \$12,000 gain is fully taxable. The income has some additional characteristics that apply to machinery, equipment, and similar property.

First, the \$12,000 gain is all taxable in the year of sale, regardless of whether the full amount is received or there is a down payment and installment payments. Gain due to depreciation previously taken is fully taxable in the year of sale for most machinery, equipment, and other personal property and is taxed as ordinary income rather than as a capital gain. The \$12,000 is added to the other income on the seller's income tax return that year.

That may not cause problems when you are selling one tractor, but it can come as a real surprise when you are selling a whole line of machinery at much more than its book value. All the gain is taxable in the year of sale. Gains from the sale of machinery and equipment (and purchased breeding livestock) are eligible for farm income averaging, reported on Schedule J, and may help reduce the income tax liability from large sales of property subject to depreciation recapture.

### **Gain is Not Farm Income**

Gain from the sale of farm machinery is not "farm income" for determining whether you must file "estimated income tax." You are not required to file estimates if 2/3 of your total gross income is from farming in the current or prior year. If less than 2/3 of your income is from farming, you fail the 2/3 income test in the year of sale. If you did not meet the 2/3 test in the previous year, you may incur penalties and interest for not filing estimates. The rules and tests are not simple, so talk with a professional to check about these and other implications before entering into a sale.

### **Gain Does Not Affect Social Security**

Gain from the sale of farm machinery is not self-employment income for Social Security purposes. The gain is not subject to self-employment (Social Security) tax. It is not earned income and therefore does not reduce the amount of Social Security received by the seller.

### **Selling Livestock to Children**

Livestock, particularly breeding livestock, are among the first things usually transferred from parents to children. If you hold breeding livestock more than 1 year (more than 2 years for horses, cattle, or poultry) and use it in your trade or business, the gain or loss from its sale qualifies for capital gains treatment.

### **Raised Breeding and Market Animals**

The same rule applies to livestock sales that applies to most other assets. The difference between the selling price and the property's "income tax basis" is taxable income. The difference here is that with raised livestock the basis is zero. Thus, the total sales price is taxable income. The basis is zero because all the costs associated with raising the livestock were tax-deductible expenses in the year incurred.

The “zero basis” is also important for livestock transferred by gift. As discussed in the section on gifts, the “fair market value” of the livestock determines the value of the gift for gift tax purposes. However, the person receiving the gift gets the donor’s basis (zero). Thus, when the person who received the livestock sells them, the sales value is taxable income.

### **Purchased Breeding Livestock**

The tax treatments of purchased market livestock and purchased breeding livestock are slightly different. Purchased breeding stock are eligible for depreciation. Market livestock are not depreciable and do not qualify for capital gains. The sale of purchased breeding livestock is treated the same as the sale of machinery and equipment for income tax purposes as discussed previously.

Let’s look at purchased breeding stock first, using a simplified example. Assume that a farmer bought a two-year-old heifer for \$1,000. Two and one-half years later the farmer sells it to a daughter for \$750. Does the farmer have a gain or loss? How much? First, even if a loss occurs, a person cannot deduct a loss on a sale to a related party.

Does the farmer have a gain? That depends on the amount of depreciation the farmer has taken on the heifer. If the farmer took less than \$250 of depreciation, the adjusted cost basis is more than \$750 so there is a small loss that cannot be claimed because it is a sale to a related party. If the farmer took more than \$250 in depreciation (basis less than \$750), the gain would equal the difference between the cow’s adjusted cost basis and the sales price.

What if the farmer had never depreciated the cow? Depreciation is “allowed or allowable,” meaning that the IRS assumes depreciation is taken even if it is not. The farmer may not deduct the unclaimed depreciation in the current year or any later tax year. The farmer could file amended returns, claim the depreciation, and possibly benefit from depreciation not taken. An amended return must be filed within 3 years of the date of filing the original return, or within 2 years of the time the tax was paid, whichever is later. That would not eliminate the gain, but it would reduce taxable income in previous years and possibly generate a refund.

### **Purchased Market Livestock**

Purchased market livestock have a basis equal to their cost. This “cost basis” is deducted on the tax return in the year the animals are sold. The costs associated with raising the market livestock are deductible in the year incurred and do not increase or decrease the livestock’s basis. Figure gain by subtracting basis from sales price. The difference is taxable income or loss. Losses are not allowed on sales between related parties.

### **Selling Raised Grain, Hay, and Inventories**

The income tax treatment of a sale of raised inventories is fairly straightforward in most cases. Raised inventories usually have a zero income tax basis, which means that their total value is taxable when they are sold. Treat sales to family members the same as sales to others. However, there is one important provision of interest to farmers who retired the previous year and do not want to reduce their Social Security benefits in the year of sale.

### **Sales After Retirement**

The month a person is entitled to begin receiving Social Security benefits (retirement, disability, Medicare, etc.) is his or her “month of entitlement.” Once a taxpayer is entitled to Social Security benefits, those

benefits may be reduced by earned income. The sale of raised farm products is earned income in most cases. However, farmers are permitted to exclude the sale of stored crops (hold-over exclusion) from earned income for determining if they exceeded the annual Social Security earnings limit. This holdover exclusion applies regardless of when the stored crops are sold after entitlement. More precisely, this is earned income received in a taxable year after the year of entitlement from services performed during the year prior to the month of entitlement.

Since most crops in Ohio are harvested in the fall, it is suggested that farmers delay retirement until their last crops are harvested and stored. Then, if December becomes the month of entitlement, grain income from this last crop sold in the next, or later years, can be excluded from earned income in those years and not reduce benefits. However, when the crop is sold, it will still be subject to both income and self-employment taxes.

This rule does not apply to income received by an individual from a trade or business of buying and selling products produced or made by others. There are a number of other rules about self-employment income that also impact this type of transaction.

## **Required Minimum Interest Rates**

The Internal Revenue Service (IRS) has specified minimum rates of interest for several common farm transactions. There are minimum interest rates for seller financing and for loans of cash.

### **Seller-Financed Sales**

The minimum rate for most seller-financed transactions is 9%, or the “applicable federal rate,” whichever is lower. However, there is a special 6% rate available for certain farm real estate transactions (discussed below). In general, the interest rules operate by requiring the parties to report interest as if the required rate had been paid from the borrower to the lender. Frequently, this causes an unexpected tax burden on the buyer, seller, or both.

The “applicable federal rate” fluctuates each month based on the interest rate paid on outstanding marketable obligations of the US government. The rates are published each month in the Internal Revenue Bulletin and many financial periodicals. They are also available from the IRS website at <http://www.irs.gov/taxpros/lists/0,,id=98042,00.html>.

There are actually 12 different rates depending on the length of loan and the compounding method chosen. The applicable federal rate is the lesser of the rate for the month of the seller-financed sale or the previous two months. For seller-financed sales for \$2.8 million or less, the required rate cannot exceed 9% compounded semi-annually (9.2% compounded annually, 8.9% compounded quarterly, or 8.84% compounded monthly).

### **6% Farm Real Estate Loans**

The required minimum interest rate for land sales of \$500,000 or less (per year) between family members is 6% compounded semiannually. Buildings, tile lines, fences, personal residences, etc., are not land and do not qualify for the 6% rate. They are subject to the “applicable federal rate” compounded semiannually.

### **Gift Loans**

Occasionally parents loan children money for little or no interest. The general rule requires them to charge the “applicable federal rate.” However, there are two exceptions that eliminate the minimum interest requirement for many loans.

First, the interest rules do not apply to a loan between individuals for any day that the total outstanding loans between the individuals is \$10,000 or less. This exception does not apply if the loan is directly attributable to the purchase or carrying of income-producing assets.

Second, if parents loan large amounts of cash to children at no interest, the investment income earned by the children is taxable to the parents. However, the amount of interest is limited to the borrower's net investment income on any day the total outstanding loans between the borrower and lender is \$100,000 or less. For the purposes of this rule, if the borrower's net investment income is \$1,000 or less, it is treated as if it were zero. Thus, if the total outstanding loans are \$100,000 or less and the borrower's net investment income is \$1,000 or less, the interest rules do not apply to the loans.

\* District Specialist, Farm Management, Northeast District (Emeritus) and District Specialist, Farm Management, East District, Ohio State University Extension.

November 2003

---

All educational programs conducted by Ohio State University Extension are available to clientele on a nondiscriminatory basis without regard to race, color, creed, religion, sexual orientation, national origin, gender, age, disability or Vietnam-era veteran status.

Keith L. Smith, Associate Vice President for Ag. Adm. and Director, OSU Extension.

TDD No. 800-589-8292 (Ohio only) or 614-292-1868