Don’t let capital gains hold you captive

Farm Transition

By Steve Bohr

Making tough decisions for this transition is an art, not a science. There is no textbook answer that is the same for every family.

A majority of the land in our state is owned by people age 60 or older.

A majority of these land owners had an opportunity to buy land in their lifetime under terms that cash-flowed on its own merits.

Their children or grandchildren may never have this same opportunity.

Insert any price into the sentence, “My dad never thought I would be able to make it paying $____ an acre for that land.” Most of us can appreciate this statement because we have either said it or heard it.

Even though it may not seem so at the time, the easier days of land acquisition may have passed us by.

The current land-owning generation appears to have acquired most of their land before their parents’ estates settled.

I’m fearful if the future land-owning generation waits until their parents die, our industry may miss out on an opportunity to continue the institution of the family farm as we currently know it.

Stepped-up basis

Basis is the amount of tax you have paid for your property. It’s a tax “starting point.”

If you buy land at $1,000 per acre, that is your basis. If you sell it for $8,000/acre, you will pay the difference in capital-gains tax.

One of the best estate settlement concepts is adjusted basis.

If you die owning that land, it will receive a basis adjustment to the fair-market value of the property at death. This has been labeled “stepped-up basis.”

Basis adjustment at death is extremely important for a farm family for grain, equipment, livestock, fence, tile, wells, building sites and maybe even soil fertility.

These are all current assets that will likely turn over in the future with little or no basis due to depreciation.

If a family receives an adjusted “stepped-up” basis at death, the heirs will receive a new depreciation schedule on these assets. This could create a favorable income tax result for the next generation.

In a case where dad dies with depreciated equipment, Mom will be able to depreciate that same equipment if she keeps it.

At mom’s subsequent death, the children may be able to depreciate the same line of equipment for the third time if they keep it.

This is one of the ingredients that give credence to the trend of a “farmer never retiring.”

Three concerns

There are three potential problem areas with basis adjustment.

First, the name “stepped-up” implies that assets always go up in value. What if an asset decreases in value from the price you acquired it?

If this were the case, the asset would get a “stepped-down” basis adjustment in an estate.

If you purchase land at $10,000 per acre and at death its appraised fair-market value is $6,000/acre, your heirs would lose $4,000/acre in basis as the estate would get a “stepped-down” basis adjustment.

GUESS WHO paid the tax on this “loss of basis?”

This could become a real possibility in the near future.

Secondly, the concept of adjusted basis encourages holding assets until death. A high percentage of the time, holding assets until death to get a basis adjustment makes sense.

There are, however, times when selling or transferring assets to the next generation makes sense as well.

You should not disregard the possibility of transferring an asset solely based on the possibility of a basis “step-up” at death.

If the person or persons you acquired your land from thought this way, you may not own the land holdings you do today.

Lastly, a basis adjustment at death encourages a psychological “open invitation” to liquidate.

Heirs sometimes hear, “you can sell the assets tax-free” and make a bad decision to sell off assets in haste after death.

This week’s example

I recently met with a family who was interested in transitioning their remaining farm assets while living.

They were relieved to know they could set any price they wished as long as they didn’t discount the sale price by more than $10.5 million (lifetime gift exclusion of $5.25 million for each spouse).

Mom and dad wanted to clean up the distribution of their estate with a plan that would provide liquidity if needed for future medical expenses.

Their sons had sweat equity and weren’t getting any younger.

They decided their “family price” to sell land to their farming sons was $7,000/acre. They had purchased their 320 acres for $800,000.

Their residence would be valued about $300,000 (gain on a personal residence can be excluded up to $500,000 of gain).

Therefore, the total basis in the farm was about $1.1 million. If they sold it for $2.2 million ($7,000/acre), they would have a capital-gain ratio of 50 percent.

At first glance, this amount of capital gains is upsetting to most farm families. The key is to manage these gains over a period of years.

Mom and dad could save income tax (not to mention property tax and maintenance/upkeep) by selling the farm on a contract.

They would go from receiving rent of $90,000 taxed at ordinary rates (15 to 25 percent federal marginal tax rate) to a 20-year contract at 3 percent interest with an annual payment of about $147,000 ($460/acre).

IN THE first year of the contract, about $66,000 would be taxed as interest (15-25 percent marginal rate), and $81,000 would be considered principal. Of that, $40,500 would be tax-free return of basis and $40,500 would be taxed at lower capital gains rates (0-15 percent marginal rate).

This family is considering reducing the sale price to $1.4 million (a reduction of $800,000 off the family price) to get a 3-percent, 20-year contract payment down to $94,000 ($292/acre).

To complete this option, the farming sons would transfer $400,000 of existing life insurance they have on their parents to make up the difference to their non-farm siblings.

What is it really worth?

Some would say land is worth what two bidders will pay at an auction. Others might say land is only worth what it can produce in income to support itself.

We all know what goes up, must come down.

One of the biggest advantages of transferring real estate while you are alive is control — deciding what your land is worth yourself.

As with most difficult decisions, the decision to transfer assets to the next generation is not easy.

Making tough decisions for this transition is an art, not a science. There is no textbook answer that is the same for every family.

The best you can do is to assemble a team of selected advisers you can count on to help you make sound decisions with a comprehensive understanding of various planning options that will meet your individual goals.

Don’t be held captive by capital gains tax. The cost (if managed) may be cheaper than the estate and family costs of deferring the transition until your death.

My hope is your family will find the way to an appropriate outcome in this critically historical time for estate and farm succession planning.

For 21 years, Steve Bohr has been a partner in the farm continuation firm of Farm Financial Strategies Inc. For additional information on farm continuation issues or if you have a question, contact Bohr via email at Bohr@FarmEstate.com or call 800-375-4180.