6-8-2012

The Era of Income Tax Basis

Neil E. Harl
Iowa State University

Follow this and additional works at: http://lib.dr.iastate.edu/aglawdigest

Part of the Agricultural and Resource Economics Commons, Agricultural Economics Commons, Agriculture Law Commons, and the Public Economics Commons

Recommended Citation
Available at: http://lib.dr.iastate.edu/aglawdigest/vol23/iss12/1

This Article is brought to you for free and open access by the Journals at Iowa State University Digital Repository. It has been accepted for inclusion in Agricultural Law Digest by an authorized editor of Iowa State University Digital Repository. For more information, please contact digirep@iastate.edu.
The Era of Income Tax Basis
-by Neil E. Harl

Over the past several decades, estate planning has been dominated by the era of federal estate tax. The federal estate tax exemption of $60,000 before 1977 for an estate with a tax rate ranging from three percent for taxable estates of $5,000 or less to a tax rate of 77 percent for estates over $10,000,000 has given way to an applicable exclusion amount of $5,120,000 for deaths in 2012 and a tax rate of 35 percent. That has meant a sharp drop in the percentage of farm and ranch decedents (and of all decedents) filing a federal estate tax return and paying federal estate tax.

At the same time, average per acre Iowa farmland values have risen dramatically (from $88 per acre in 1941 (and $1214 in 1990) to $6,708 per acre in 2011. Many portfolios of decedents have also experienced increases in the values of other investments over the same time periods. That has meant that, for many decedents, with the income tax basis remaining relatively stable (increased by improvements made and decreased by depreciation claimed), the amount of potential gain has increased enormously in recent decades. That has meant that income tax basis, which determines the gain on sale or other taxable disposition along with the selling price, has taken on much more importance and promises to figure prominently in financial planning going forward.

Decisions—Sell it? Gift it? Or die owning it?

The relatively low income tax basis for much of the farmland (and other assets) owned by decedents, has resulted in eye-popping comparisons as to how to dispose of the property.

Example 1—Sell the land. Let’s assume 400 acres of unimproved land bought for $88 per acre in 1941—the average price then in Iowa. Today’s income tax basis would be $35,200. Assume also that it is sold for $6708, the latest average price per acre in the state. The selling price would be $2,683,200. The gain for income tax purposes would be $2,648,000. At even a 15 percent capital gains rate, the income tax would be $397,200.

Example 2—Gift the land. If the 400 acres are gifted, during life, to the four children, the income tax basis for much of the farmland (and other assets) owned by decedents, has resulted in eye-popping comparisons as to how to dispose of the property.

State Taxation of Agriculture
Agricultural use 95
Workers’ Compensation
Scope of employment 95
In the News
Offers in compromise 95
IRS tax forums 95
Example 3 – Die owning the land. If the landowner dies owning the land, the gain on the property until the time of death of $2,648,000 would be wiped off the tax books and the income tax basis of the property in the hands of the estate or the heirs would be $2,683,200, the fair market value at death. The estate (or the heirs) could sell the property at its fair market value of $2,683,200 with no income tax due.

From a tax perspective, there is no doubt which would be the most advantageous in terms of family wealth – holding the farmland until death is far and away the best strategy. There may, however, be other pressing objectives – such as generating funds to pay assisted living expenses. Interestingly, this strategy is what many decedents, deep down, want to pursue. They like land ownership, it provides a steady income and they have usually have confidence in land as an investment.

How to protect the new basis at death?

Obviously, merely retaining ownership of the land until death is all that is needed, at least under current tax law. But there are some strategies that could endanger the new basis strategy.

Successive life estates. One estate planning strategy that is surfacing in some parts of the country that can jeopardize the new basis at death is the use of successive life estates. In one recent case, grandfather bought a 320 acre farm in 1932 for $100 per acre. Hearing about a probate avoidance strategy from other family members, he transferred the farm to the children for life, then to the grandchildren outright, but with a retained life estate in his name so long as he lived. The grandfather died in 1940 with the land included in his estate (at $150 per acre, its fair market value), because of his retained life estate. However, the granted life estates to the six children did not produce an adjustment in basis. The last of the children have now died and the grandchildren, all living off the farm, want to sell the land. The grandchildren were absolutely horrified to learn that the income tax basis on the farm (now valued at $9,000 per acre) is only $150 per acre, the fair market value at grandfather’s death in 1940. That would mean gain of $2,832,000 in total or $472,000 for each of the six children.

“Dynasty” trusts. A strategy some have used, in states that have repealed the Rule Against Perpetuities (which limited how long property could be held in trust to the duration of a class of lives in being plus 21 more years), has been to transfer assets to a trust that lasts forever. The property in the trust would never again be included in anyone’s estate and would never again have a new basis at anyone’s death. Imagine, what the gain would be if the heirs managed to engineer a sale after 300 or 400 years!

Failing to include the land in the estate of the surviving spouse. One strategy that produced disappointing results involved a husband and wife who transferred their farm and some lake-front property, all owned in joint tenancy, to a trust with the income to be paid to each of them and then to the survivor after the first death. What the couple did not know (and, apparently neither did the individual who set up the trust) at the wife’s death in 1985, half of the value was included in her estate (and received a new basis of $325,000. However, the transfer to the trust had severed the joint tenancy and cases have held that the joint tenancy tax rules do not apply unless the joint tenancy survived until death which it did not. At the husband’s death in 2011, his half of the property was included in his estate and received a new basis of $1,600,000. A life estate (which was a granted life estate) in his deceased wife’s half had passed to him but granted life estates do not produce a new basis at the later death. Therefore, the income tax basis of the property at the father’s death passing to their three children was $325,000 plus $1,600,000 or $1,925,000 in total for property valued at $3,200,000. The three children had some difficulty believing that they would have gain of $1,605,000 on sale of the property involved.

Usually, it has been viewed as wise to divide the property between the spouses equally. Now, with greater emphasis on income tax basis, if it becomes reasonably clear that one spouse is likely to die first, rather than to load up that spouse with property, it might be wise to do just the opposite under the assumption that property values will continue the long-term inflationary trend upward.

ENDNOTES


2 I.R.C. §§ 2001(c), 2010(c), added by Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3300 (2010). There is no assurance that the federal estate tax will not “sunset” back to a $1,000,000 exclusion and a 55 percent rate after December 31, 2012 but that seems unlikely with a greater likelihood of a continuation of 2012 exclusion and tax rate levels.

3 The latest national data, from 2010, show 6,711 estates out of approximately 2.4 million deaths actually paid federal estate tax and out of that number, 6,711, 990 decedents with taxable estates reported some farm property in 2010. See Harl, Farm Estate and Business Planning: Annotated Materials p. 4-1 (April 18, 2012).


5 See Duke of Norfolk’s Case, 3 Ch. Cas. 1, 22 Eng. Rep. 931 (Ch. 1682).

6 I.R.C. § 2040.