Income Tax Aspects of Property Transfers

Property can be transferred by sale or gift during life, or by inheritance at death. The income tax consequences of each type of transfer are different.

Income Tax Basis
To understand the income tax liability on the sale of assets, one must understand the concept of basis. Simply, basis is that portion of the asset value that has been accounted for in previous tax handling. Often, basis is the cost, but in some instances, basis may differ from cost. There are three rules that help determine how much of the income from the sale of an asset will be subject to income tax liability.

Purchased Assets
The first rule of basis relates to assets that have been purchased during life. For purchased assets, you take the purchase price of the asset, add to that the cost of any improvements made during life and subtract any depreciation claimed. Thus, if property was purchased in 1940 for $10,000, improvements totaling $4,000 were made, and $2,000 worth of depreciation was claimed, the income tax basis would be $12,000.

If the asset is sold, any amount received greater than the $12,000 basis is a gain. Except for sales to a related party, any amount received less than the $12,000 basis would be a loss. For capital losses, the deductibility may be limited to offsetting capital gains plus up to $3,000 of other income per year (for individuals). The income tax basis is subtracted from the selling price to determine gain or loss.

The basis indicates how much of the selling price will be taxable gain.

Assets Acquired by Gift
The second rule applies to assets acquired by gift. For that type of property, you go back to the donor’s basis. That provides the starting point for your income tax basis. To the donor’s basis you add improvements since the date of the gift and subtract depreciation taken. You may, in some instances, add part of any gift tax paid onto the basis.

Again consider that property was bought in 1940 for $10,000, improved by $4,000, with $2,000 in depreciation claimed prior to the gift. Let’s assume that the property at the time of the gift is really worth $100,000. The federal gift tax would be based on the $100,000 fair market value, but the $12,000 figure still carries over to the new owner as the income tax basis.

If the person receiving the property by gift should sell it a few years later for $110,000, the income tax liability would be based on the $110,000 selling price, minus the basis. The basis would be $12,000 (donor’s basis), plus the cost of improvements since the date of the gift, and any gift tax paid attributable to the net appreciation in the property, less depreciation claimed. In effect, the person receiving the property as a gift shoulders the potential income tax liability of the donor.

Inherited Property
The third basis rule applies to inherited property. Using the same example, the property with an income tax basis of $12,000, but worth $100,000, is held by the owner until death. The difference between the $12,000 basis and the $100,000 value is not considered. The new basis becomes $100,000 for the new owner who inherits the property.

While the federal estate tax and state inheritance tax will likely be based on the $100,000 fair market value at the time of the gift, the basis to the donee (receiver) is the fair market value.

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value of the property, elimination of income tax on the $88,000 of gain is a major advantage. If fair market value at death is less than the basis, the decedent’s estate receives a step down (rather than a step up) in basis. Thus, if property acquired for $200,000 (no improvements and no depreciation) had dropped to $120,000 at death, the potential $80,000 loss is eliminated.

There is an exception to the general rule of a new income tax basis at death. If appreciated property is given away within one year of death and then inherited back by the donor or the spouse of the donor, or the property is sold and the proceeds are inherited by the donor or spouse of the donor, the property does not receive a new income tax basis at death.

**Advantages to Holding Assets**

One of the major advantages of holding property until death has just been shown. For those with gains in assets, the advantage of receiving a new income tax basis may overshadow the potential estate or inheritance tax liability, or at least a significant part of it.

If the property is land, the land held until death may be valued under the special use valuation rules. That is a second major advantage. But special use valuation does not apply to transactions by sale or gift.

There is one type of asset that does not receive a new income tax basis at death, however. This is what is called “income in respect of decedent.” This is a category of income that is so close to being earned income that a new basis is not permitted.

If the decedent has been renting out farmland under a non-material participation crop share lease, the stored crops and growing crops are income in respect of decedent and the gain is not eliminated. Accrued interest on Series E U.S. Savings Bonds is another example that continues to be taxable after death.

Installment sales, or installment contracts for the sale of assets such as land, produce income in respect of decedent, also.

**Sale of Residence**

There is an income tax exclusion available on the sale of a residence. This treatment applies to urban residences, or to the sale of the farm residence either as part of the farm or if sold independently.

A taxpayer is allowed a $250,000 exclusion for gain on the principal residence ($500,000 on a joint federal income tax return) no more frequently than once every two years. To be eligible for the exclusion, a taxpayer must have owned the residence and occupied it as the principle residence for at least two of the last five years before sale or exchange.

To be eligible for the $500,000 exclusion, either spouse can meet the ownership test, both spouses must meet the use test, and neither spouse can have sold or exchanged a residence within the past two years. A taxpayer’s period of ownership of a residence includes the period during which the taxpayer’s deceased spouse owned the residence. For transfers of residences incident to a divorce, the time the taxpayer’s spouse or former spouse owned the residence is added to the taxpayer’s own period of ownership.