Matters of Tax for Landowner Succession Planning

by Matthew Von Schuch

Taxes are an important part of succession planning for landowners who intend to keep their land in the family. There are principally two types of taxes that landowners and their advisors must consider in the developing a succession plan: income taxes and gift and estate taxes. These taxes will be imposed on either the sale, gifting, or inheritance of the principal part of a landowner's legacy: his land. Below you will find answers to some of the more frequent questions landowners have about planning for these two types of taxes.

How do income taxes affect a landowner's succession plan?

Income taxes affect the value of the land both in the landowner's hands and in the hands of his or her heirs. Land and other associated assets like buildings, land improvements, roads, landscaping, etc., are capital assets. When held for more than one year, any gain from the sale of these assets are taxed at preferential federal tax rates up to 20 percent, the regular Virginia income tax rate up to 5.75 percent, and may be subject to a 3.8 percent net investment income tax. While a landowner may intend for his or her land to stay within the family, transferring land with a large built-in income tax will place a burden on the landowner's heirs limiting their flexibility (i.e., to make inter-family sales) and jeopardizing their ability to fulfill the landowner's legacy.

How are the gains from the sale of land and other capital assets taxed?

Taxable gains are realized when a capital asset, like land, is sold or exchanged for money or other property. Taxable gains are calculated by subtracting the landowner's adjusted basis in the asset from the amount of money and property received from the sale. For example, when an asset with a $50 adjusted basis is sold for $100, the seller has a $50 taxable gain.

How do you determine adjusted basis in a capital asset?

First, a landowner's original basis in the asset is determined based on whether the asset was acquired by purchase, gift or inheritance. The original basis of a purchased asset is the cost paid to acquire the asset. The original basis of a gifted asset is the lower of either the donor's basis in the asset or the fair market value of the asset at the time of the gift. The original basis of an inherited asset is the fair market value of the asset on the date of decedent's death. Second, the landowner's original basis is adjusted by increasing it for any costs paid to improve the asset and decreasing it for any depreciation deductions taken on the asset.

The dichotomy between the basis of gifted and inherited assets is an important planning consideration. The preference is to gift high basis property and devise (give through inheritance) low basis property. This will reduce the income taxes the recipient will pay if some or all of the property is later sold, whether by choice or out of necessity.

What are estate and gift taxes and how do they work?

Estate and gift taxes are imposed on the value of property that a person transfers during his or her lifetime or on death. It is important to note that gift and estate taxes are imposed on the total fair market value of the property transferred—so basis is not considered. The top marginal tax rate is 40 percent. A generation-skipping tax is also imposed on the value of property given or devised to a person who is more than one generation removed from the donor, i.e., grandparents to grandchildren. This extra 40 percent transfer tax is meant to prevent a family from avoiding one layer of estate taxes by skipping generations.

What are the most important estate and gift tax provisions to take advantage of in succession planning?

First, and foremost, each person is granted a lifetime exclusion permitting the transfer of $5.49 million (adjusted

for inflation) worth of property without incurring any gift or estate tax. This exclusion is portable between spouses so that a married couple can transfer almost $11 million without being subject to any estate or gift taxes. There is also a $5.49 million generation-skipping tax exemption although it is not portable between spouses.

Second, transfers of property to spouses and charities are not subject to estate and gift taxes. Unlimited deductions are available for both such transfers.

Finally, there is a $14,000 annual gift tax exclusion. This allows each person to give up to $14,000 to as many individuals as desired each year without triggering gift tax and without using up any portion of his or her $5.49 million exclusion. Married couples can give up to $28,000 to as many individuals as they desire each year.

Is it better to make lifetime gifts or give property as an inheritance?

Gifting property, or an interest in property, or a limited liability company owning property, during the donor's lifetime has the benefit of removing from the donor's taxable estate any appreciation in the property's value that occurs after the gift is made. The preference is to gift property that is currently undervalued (say due to a market downturn), property that will significantly appreciate in value before the donor's death (say valuable agricultural land owned by a young couple), or property that can be divided into smaller pieces and gifted under the annual exclusion amount. Any growth in value of this property after the gift will escape the donor's estate tax.

How do income taxes figure into deciding whether to make lifetime gifts?

The estate tax benefit of removing appreciated value from the landowner's estate must be weighed against the potential built-in income tax gain the recipient will take with the property due to a lower, carryover basis.

Where should landowners focus tax planning: estate taxes or income taxes?

It depends on the landowner's net worth. Landowners who are not currently, and are not likely to be, subject to gift and estate taxes due to the high $5.49 million lifetime exemption should focus on income tax planning by ensuring that beneficiaries take property with the highest basis possible. On the other hand, for landowners who are, or may be, subject to gift and estate taxes, their priority should still be minimizing gift and estate taxes—in most cases a 40 percent estate tax on the total value of an asset is greater than a 29.55 percent income tax on the gain from the future sale of an asset. Estate planners and tax advisors ought to be engaged to help those landowner caught in the middle develop a flexible plan that address both income and estate taxes.

How does owning land in a limited liability company (LLC) change the income and estate tax treatment discussed above?

For single member limited liability companies—that is, LLCs with only one owner—there is no change. The IRS completely ignores their existence and treats the owner of the LLC as if he or she directly owned the land. Moreover, owing a single member LLC, will not change any estate taxes that may be due because the value of the LLC interests are going to be the same as the value of the land it owns. Things become more complicated, however, when more than one person owns an interest in a LLC.

On the income tax side, when a LLC has multiple members it is treated as a partnership. Partnerships are pass-through entities. Partnerships pay no tax; their partners do. For example, if a partnership sells land for a gain, the partnership will calculate its gain from the sale and allocate the gain among its partners who will each pay tax on their allocable share of the gain. In simple partnership structures, the income tax treatment of a multi-owner LLC will be the same as if the multiple owners directly owned the land. Partnership tax and accounting becomes quite complicated, however, when a LLC generates losses, uses debt financing, operates other businesses, or when owners turn over.

On the gift and estate tax side, multi-member LLCs present planning opportunities. The value of small, minority interest in a LLC can be reduced by structuring them to have little or no managerial control and restricting their transferability. So, a one-third interest in a LLC owning land may be worth less than a direct one-third interest in the land. While a landowner has the right to use the land, control the land, and to force a sale of the land, a minority interest in a LLC that owns land can be structured so that its owner has none of these rights. By reducing the value of a LLC interest in this way, the gift and estate tax paid on the transfer of such interests can also be reduced.

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