Sustaining New England’s rural communities means keeping viable, working farms in business. Farmers and others interested in maintaining the working landscape need to plan carefully in order for farms to be successfully transferred. This is true if the transfer is within a family from one generation to the next or between unrelated retiring and beginning farmers. One of the most important aspects of a successful transfer is dealing with accumulated farm assets.

Retiring farmers that I have worked with know that they will owe capital gains tax if they sell assets. They fear that these taxes will “take it all.” To make matters worse, retiring farmers often don’t have a clear understanding of tax laws concerning gifts and inheritance. This fact sheet tries to clarify the three common ways for an owner to transfer assets—sale, gift, inheriting—and touches on the role that farm assets play in farmers’ retirement planning.

Ways to Transfer Farm Assets

Most farmers build up their assets over a lifetime. By the time they begin thinking about estate planning, farm transfer, or retirement, there are many, many assets to think about—assets like inventories, livestock, machinery and equipment, buildings, and land. Transferring these assets takes a considerable amount of planning. Farmers usually have a clear understanding of how to accumulate assets, but have a shaky understanding of how to transfer assets.

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There are three common ways to transfer an asset. You can sell it. You can give it away. Or you can keep it until you die and someone will inherit the asset. Simple isn’t it? Sell it. Give it away. Keep it so someone can inherit. (Sometimes as part of estate planning, people may transfer assets to a trust.)

Background Information: Tax Basis

Now consider tax basis and it gets a little more complex. The tax basis is “the amount of money left” in a capital asset after depreciation. Tax laws and tax rules are very specific about how to calculate basis. This isn’t anything that people usually think about, but basis is a very important consideration in how to transfer an asset.

Whenever you buy a capital asset, your basis is what you paid for it. Then you depreciate that asset.
a little bit each year. Depreciation follows tax rules; it is a non-cash expense that farmers declare on their 1040 F farm tax return. Adjusted tax basis is what you paid for the asset minus all of the depreciation that you have taken on that asset. Eventually you will finish depreciating the asset, and your adjusted tax basis will be zero.

Depreciation
Most assets depreciate—machinery, equipment, purchased livestock, and buildings. The Internal Revenue Service (IRS) does not allow anyone to depreciate land or a private home. Your initial basis in an asset stays with you until you transfer the asset. Raised livestock have a basis of zero. You claimed the expenses of raising them on your annual 1040 F tax return (you "expensed" them). So, when you sell livestock that you raised, all of the money you receive is gain.

Sometimes you may add to the basis of an asset—such as a motor job on a tractor, or a new roof on a barn. In those cases, you will likely depreciate the improvement over a number of years. Improvements to land (like clearing to make more pasture or cropland) or your private home (like a new kitchen) don’t depreciate; instead, they get added to the original basis. This is why it is important to keep records on improvements.

So, your basis in an asset changes over time. The basis equals purchase price minus depreciation (taken in all years or “accumulated depreciation”) plus non-depreciated improvements. As an example, imagine a used tractor Kim bought for $7,500 and has owned for 8 years, and is all “depreciated out.” Her basis in the tractor is now zero.

<table>
<thead>
<tr>
<th>Calculating basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Example with used tractor:</td>
</tr>
<tr>
<td>Purchase Price</td>
</tr>
<tr>
<td>minus Depreciation</td>
</tr>
<tr>
<td>plus Improvements</td>
</tr>
<tr>
<td>equals Basis</td>
</tr>
</tbody>
</table>

Selling
Now, how does your basis affect transferring those assets?
In a sale, IRS calculates gain by subtracting basis from sales price. Sales price minus basis equals gain. You are taxed on your gain. Actually, it is a little more complicated than that; costs of the sale, such as advertising and commissions, are also subtracted. So it is sales price minus basis minus costs of sale equals gain. You are taxed on your gain. Beginning with the 1998 tax year, the federal tax on capital gains is either 10% or 20%, depending on your income tax bracket.

Capital Gains
Look at current IRS publications for the latest capital gains tax rate, as this rate is a political football. Some states tax capital gains as well. It pays to estimate your capital gains before a sale. This means visiting with the person who does your taxes before the sale, so you can get a feel for your potential tax liability. Some people are surprised after the sale and may even need to borrow money to pay capital gains taxes. So it’s a good idea to think about capital gains before any sale.

Many farmers incorrectly think that IRS takes the amount of debt against an asset into consideration when calculating capital gains tax. Uncle Sam

It pays to estimate your capital gains before a sale.
does not care how much money you owe. You pay off debt with after-tax dollars. Sales price minus basis equals gain. Debt does not enter that equation. Remember that.

What’s the bottom line? Let’s look at an example, to help clarify. Think about that used tractor. Kim bought it for $7,500, kept it for 8 years, and depreciated it over that time. This brought her basis in the tractor to zero. Then Kim sold it for $5,000, and paid a $500 commission on the sale. (Remember: Uncle Sam allows us to subtract commissions, advertising, fees, and other costs of a sale from the sales price, so we are not taxed on these costs.) If we subtract the basis and the commission from the sales price, we have a gain of $4,500. She is taxed on the gain. Kim is in the 20% tax bracket for capital gains, and 20% of the $4,500 gain equals a tax of $900 on that sale. Kim still owes $350 on the tractor. How much cash does Kim have left after paying taxes and paying off the note on the tractor? She sold the tractor for $5,000, minus the $500 commission, minus the $900 capital gains tax, minus the $350 on the debt. So she has $3,250 in cash. Notice that Kim pays off the loan with after-tax dollars.

Calculating gain
Example with used tractor:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Price</td>
<td>$5000</td>
</tr>
<tr>
<td>minus Basis</td>
<td>- 0</td>
</tr>
<tr>
<td>minus Cost of Sale</td>
<td>- 500</td>
</tr>
<tr>
<td>equals Gain</td>
<td>$4500</td>
</tr>
</tbody>
</table>

(Note: You are taxed on the gain.)

Calculating cash (amount you keep)
Example with same used tractor:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Price</td>
<td>$5000</td>
</tr>
<tr>
<td>minus Cost of Sale</td>
<td>- 500</td>
</tr>
<tr>
<td>minus Taxes</td>
<td>- 900</td>
</tr>
<tr>
<td>minus Debt to Pay Off</td>
<td>- 350</td>
</tr>
<tr>
<td>equals Cash (you keep after sale)</td>
<td>$3,250</td>
</tr>
</tbody>
</table>

So, in a sale, the seller may pay a capital gains tax. How about the buyer? The buyer’s basis is what she paid for the asset. Then she will go ahead and depreciate that asset over time if it is kept for business use.

Installment sale
All of the above assumes that the buyer has the money to pay at once, or borrows enough to buy the asset. What about an installment sale? If the seller does the financing and receives money over time, he pays the tax over time as well. Each payment includes:

- interest, which must by law be charged and taxed as ordinary income,
- return of adjusted basis, which is not taxed, and
- capital gain, which is taxed at capital gains rate.

Taxes are due in each year that the seller receives payment. Check the Farmers Tax Guide (IRS publication 225) for details, or contact your tax preparer. (This is a very brief simplification of installment sales rules.)

Gifting
In the case of a gift, you give the asset as well as your basis to the donee (receiver). Usually in farm situations, there is no tax due from the donor (giver), nor from the donee. Not only that, the donee can depreciate the transferred basis of the gift, if it is business property. When a donor hopes to make many sizable gifts, estate planning becomes important—to come up with a plan for giving over a number of years.

Federal tax law allows everybody to give up to $10,000 per year of cash or assets to as many people as they wish to with no tax due from the donor or the donee. This is $10,000 per year per donee. Plus there is unlimited gifting between a married couple (from one spouse to another). But if you give over $10,000 to someone other than your spouse in any one year, you will start lowering something called your Unified Tax Credit (more on the Unified Tax Credit later).
$1,000,000 gift per year

Most people consider $100,000 to be a lot of money. But it isn’t so much for someone who has been collecting assets for decades. Then, you and your spouse can give your daughter and significant other $40,000 each calendar year. ($10,000 from you to daughter and another $10,000 to her significant other, plus $10,000 from your spouse to daughter and another $10,000 to her...

You might be able to give all of your assets away with no gift taxes due. The only problem is once you make a gift, that asset is gone.

significant other). Then there may be other children, and perhaps grandchildren as well. So you might be able to give all of your assets away with no gift taxes due. The only problem is once you make a gift, that asset is gone. You can’t sell it or rent it to create cash needed to buy food, or fuel, or clothes, or anything else. It is gone you have given it away. Despite the best of family intentions, you might not get it back when you really need it.

Basis of a gift

Gifting can work well. But there can be a couple of drawbacks. Remember that the basis of a gift is the donor’s basis. Seldom does a donor mention what the basis is when giving a gift. After a number of years, the basis can get misplaced. Furthermore, an asset’s basis may depend on earlier transactions, such as trades, improvements, or inheritance. When the asset is gifted or sold, it takes some effort to recreate the basis. (Another drawback to gifting is dividing large assets, like land, among several people.)

I have seen this happen when a farm family is given a house. Over the years, people replace the roof, furnace, kitchen, windows, and wiring. When it is time to sell, what is the basis? Who was keeping track? Or if land is given from one generation to the next, the basis may still be the $2,000 that Grandma and Grandpa paid in the 1940s. Then it is time to sell, and the family is facing a big capital gains tax. This brings us to one big advantage of inheriting: “step-up in basis.”

Inheriting

The third way of transferring assets is inheriting. After you die, somebody will get, or inherit, your assets. After death, assets move according to deeds or other documents of joint ownership. Then assets move according to your will. If you have no will, state law determines who will get your assets. Your estate is the value of all your assets, including life insurance, minus debt. If the total is less than or equal to $650,000 now in 1999 (increasing to $1,000,000 in 2006), your heirs will be able to inherit with no federal estate tax being due. If your estate is worth more than those values, your estate will owe a significant tax before your heirs get the assets. The federal estate tax begins at 37%. Different states have different estate taxes. Some states have estate taxes that begin at lower values than federal tax. Some states use the federal levels.

Stepped-up Basis

The basis of an inherited asset becomes fair market value on the date of death. This is called a “step-up in basis” or “stepped-up basis.” So, if the inheritor sells the asset on the next day, usually

“Step-up in basis” can be a valuable planning tool for farm families.

there would be no capital gains tax. This is because the basis would be equal to the sales price, assuming that the sales price equals the fair market value. This “step-up in basis” can be a valuable planning tool for farm families. Why? Some farm
families have assets that have highly appreciated over their basis; land is a common example.

It's a good idea to know your basis in assets, or at least have a general idea about your basis. You may not need to know your basis now, but you, or somebody you love, will eventually be concerned about your basis. Why not do them a favor and make the basis in your assets easy for them to find?

**Unified Tax Credit**

Now back to the Unified Tax Credit. Uncle Sam gives us each a Unified Tax Credit on gift and estate taxes. We use the credit to pay estate taxes that are due. For large farms, the Unified Tax Credit may not be enough to cover the entire tax that is due. Planning is very important. If we have made a gift of more than $10,000 in any year, we have used a bit of our Unified Tax Credit. Every dollar above the $550,000 will be taxed at a minimum rate of 39%. Most farms in New England can bring their estate tax exposure down to zero with proper planning. Professionals, such as attorneys and accountants, must be used to plan properly.

Remember that there is unlimited gifting allowed between spouses. "Balancing an estate" is gifting property from one spouse to the other to take full advantage of each person's Unified Tax Credit. After this balancing, each spouse will own about half of the estate. By doing this planning, you can get $680,000 multiplied by 2—or $1.3 million—of the estate to pass tax-free from one generation to the next. If your estate is valued at more than that, consider a “hypass trust” to give the control and rights to income from assets to the surviving spouse. Ownership moves to other people named in the trust, but control and income remain with the surviving spouse.

Where does a family begin? Work up a current Balance Sheet—what you own and what you owe. Date the paper. How close is it to $680,000? How much will it be in 2003? Do you have a will? It might be time for some estate planning to manage what assets you have, think about who you want to receive your assets when you die, and think about saving taxes.

**Balance Sheet**

A Balance Sheet is a tool to list your assets and debt as of a certain date, usually January 1 or December 31 of each year. Usually we list all assets (an inventory list) with an estimate of the market value of each asset. Then we list all of our debt on the same date. We subtract debt from assets to calculate Net Worth or Equity. This is an estimate of how much money would be left if all the assets were sold and all of the debt paid off. Most lenders require this statement from all borrowers each year. A balance sheet is an excellent tool to use even if you don’t borrow any money.

Most always, assets are listed on the left side of the paper. Debt is listed on the right. And net worth or equity is what makes the two sides balance, since assets minus debt equals net worth. Net worth is listed in the bottom right-hand corner. This statement always has a date.

**Important Tools:**
- Balance sheet to track these things over time:
  - assets (with an inventory list)
  - debts
  - net worth (equity)
- Depreciation schedule or book (kept by you or your accountant) to track the basis of assets

**Make sure:**
- Your lists are kept in a safe place
- (safe from fires)
- They are up to date.
- Somebody else knows where they are.
Irrevocable Trust

Some people consider there to be a fourth way of transferring an asset. You can permanently transfer ownership of an asset to an Irrevocable Trust. Such a trust usually would be part of an estate plan. A trust would own the asset, a trustee would manage the asset, and the beneficiary would get the income or other rewards from the trust.

Retiring from Farming

Usually, when the older generation is thinking about transferring assets, they are thinking about retiring. Retirement income for farm families usually comes from three sources: Social Security, savings and investments, and farm assets.

Social Security

The amount of Social Security that you are entitled to is based on how much you have paid in Social Security or Self Employment (SE) tax while you worked. For farmers, there is a nasty twist here: Farmers pay SE tax based on their profits. You can request an estimate of your Social Security benefits by calling Social Security at 1-800-772-1213, asking for the brochure Personal Earnings and Benefit Estimates, filling it out and sending it in.

Savings and Investments

The second common source of retirement income is savings and investments. This might be savings accounts or Certificates of Deposit, another business, or retirement accounts, like an IRA. Investing some money off the farm can be a good idea, as it is a type of diversification. Sometimes these off-farm assets are used for inheritance for off-farm heirs.

Farm Assets

The third source of retirement income is farm assets. These are difficult to use as retirement income. Once you start selling them, usually the amount of income from operating the farm decreases. Plus you will probably owe capital gains tax from the sale of farm assets. If you sell the farm, you might have to move out of your home. I think of farm assets as “lumpy”; they usually move in big lumps—say all of the cattle, or all of the equipment. Seldom do they get sold in small pieces to wind up in our family account as monthly income. Instalment sales, as mentioned earlier, are a way to spread the income from a sale over a number of years.

Leasing

Instead of selling, you could rent out the farm, or part of the farm. Usually, this is a temporary action for several years until you make a final decision. Leasing the farm can be an important step in thinking about a life after farming, or to help a younger generation get started in farming.

Summary: Transferring assets and retiring from farming takes planning

A farm is more than just a collection of assets. When farmers think about transferring the farm, they are hoping to transfer their excitement, hopes, and dreams on to the next generation.

All too often, however, transferring assets can be felt to be a stumbling block. And funding a retirement can seem overwhelming. But by understanding the legal processes of transferring assets and using the proper tools over time, farmers can successfully do both.