PLANNING FOR THE FUTURE OF YOUR FARM

Legal tools and strategies for farm transition and estate planning

GIFTING ASSETS PRIOR TO DEATH

Gifting assets before your death may seem like an obvious strategy for those who want to transfer assets to their heirs. If you don't need the assets, why not transfer them now rather than after your death? It's true that gifting can be a good strategy for transferring assets, but gifting can have tax implications and transferring the same assets through an estate plan may be a better strategy. In this bulletin, we discuss how gifting works, gifts and taxes, and when it is advantageous to incorporate gifting into a farm transition plan.

WHAT IS A GIFT?

According to the Internal Revenue Service (IRS), a gift is property transferred to another without receiving the full value of the property in return. Just about any asset can be a gift. Cash is the most common gift but many farm families also gift machinery, livestock, grain, and land.

MAKING A GIFT

The process for making a gift depends upon the asset being gifted. Some assets can only be gifted by executing documents while other assets can be gifted by simply handing the asset over to the person receiving the gift. Here is a list of commonly gifted assets and how they are gifted:

- **Real estate.** May only be transferred with properly executed deeds.
- **Financial accounts**. Transfer forms must be completed with the financial institution.
- **Vehicles and trailers.** Title must be transferred, and a new title issued by the county Clerk of Courts title office. Note that some smaller trailers may not have titles.
- **Machinery, equipment, livestock, and grain**. These assets do not have titles, so they are transferred by giving possession of the asset to the giftee.
- **Cash.** Direct transfer of funds to the giftee.

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USDA United States Department of Agriculture
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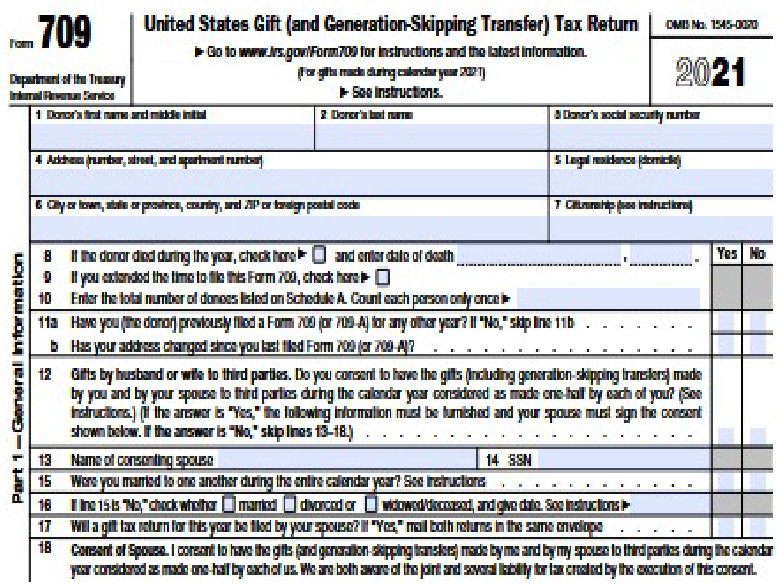
Regardless of what type of asset is gifted and how it transfers, it is good to keep a **written record** of the gift. Documenting the gift is important to avoid misunderstandings about what asset was gifted and helpful if there is an IRS audit. The written record should include a description of the gifted asset, the value of the gift, who is receiving the gift, and the date of the gift. For cash, consider using a check as further record of the gift. The person receiving the gift should also date and sign documentation to confirm that they have accepted the gift.

GIFTS AND TAXES

The gift tax. The federal government and many states assess a tax on gifts, but Ohio does not have a gift tax. The federal gift tax was developed to prevent individuals from avoiding federal estate taxes by gifting away significant assets prior to death. For this reason, it is the giver of a gift who is responsible for paying the gift tax. The gift tax begins at 18% on the first $10,000 and increases by 2% every additional $10,000, to 40% on gifts over $1 million. A giver uses IRS Form 709, pictured here, to document a gift that may be subject to gift tax.


Form 709 United States Gift (and Generation-Skipping Transfer) Tax Return OMB No. 1545-0020
Department of the Treasury Internal Revenue Service
▶ Go to www.irs.gov/Form709 for instructions and the latest information.
(For gifts made during calendar year 2021)
▶ See instructions.
2021

Part 1—General Information

1 Donor's first name and middle initial | 2 Donor's last name | 3 Donor's social security number
4 Address (number, street, and apartment number) | 5 Legal residence (domicile)
6 City or town, state or province, country, and ZIP or foreign postal code | 7 Citizenship (see instructions)

8 If the donor died during the year, check here ▶ ☐ and enter date of death
9 If you extended the time to file this Form 709, check here ▶ ☐
10 Enter the total number of donees listed on Schedule A. Count each person only once ▶
11a Have you (the donor) previously filed a Form 709 (or 709-A) for any other year? If "No," skip line 11b
b Has your address changed since you last filed Form 709 (or 709-A)?
12 Gifts by husband or wife to third parties. Do you consent to have the gifts (including generation-skipping transfers) made by you and by your spouse to third parties during the calendar year considered as made one-half by each of you? (See instructions.) (If the answer is "Yes," the following information must be furnished and your spouse must sign the consent shown below. If the answer is "No," skip lines 13–18.)
13 Name of consenting spouse | 14 SSN
15 Were you married to one another during the entire calendar year? See instructions
16 If line 15 is "No," check whether ☐ married ☐ divorced or ☐ widowed/deceased, and give date. See instructions ▶
17 Will a gift tax return for this year be filed by your spouse? If "Yes," mail both returns in the same envelope
18 Consent of Spouse. I consent to have the gifts (and generation-skipping transfers) made by me and by my spouse to third parties during the calendar year considered as made one-half by each of us. We are both aware of the joint and several liability for tax created by the execution of this consent.
Yes | No

Exceptions to the gift tax. The good news is that federal law grants many exceptions from the gift tax. A gift to a spouse or a political or charitable organization is not subject to the tax, nor is tuition or medical expenses paid for another. Additionally, federal law allows a certain value of gifted assets to pass free of gift taxes, referred to as the "annual exclusion." Gifts in excess of the annual exclusion may also be given tax free if they count toward the "lifetime exemption" from estate tax. Here's how these two types of gifts work:

1. **Annual exclusion gift.** The annual exclusion gift is truly a "free gift." A person may gift up to $16,000 annually to an unlimited number of people. These annual exclusion gifts have no gift or estate tax implications. Neither the person who gives or the person who receives the gift is subject to a tax. As an example, a person can gift $1 million tax free by giving the annual exclusion gift of $16,000 to 63 different individuals. Note that federal law indexes the annual

exclusion gift amount and occasionally increases it by $1,000 as it did in 2022, when it increased from $15,000 to the current $16,000.

2. **Lifetime exemption gift.** Many people are surprised to learn that large gifts can also be free from gift tax by counting toward a person's lifetime exemption from federal estate tax. The lifetime exemption is the amount of wealth a person can have at death that is not subject to federal estate taxes, as determined by Congress and indexed and increased each year. For 2022, the amount is $12.06 million but in 2026, the current federal estate tax law is set to sunset and the exemption will be reduced by one-half.

   Federal law allows the lifetime exemption to be "used up" during a person's lifetime. The amount of a gift that exceeds the $16,000 annual exclusion can reduce the giver's lifetime estate tax exemption by that amount when they die. If not, the amount of a gift over $16,000 can be subject to gift tax rates that start at 18% and increase to 40% on gifts over $1 million. People often choose to avoid the gift tax and reduce their lifetime exemption when making gifts over the annual exclusion amount.

The best way to explain these two important gift tax exceptions may be by using examples. **Consider the following examples**:

Example 1. John's net worth is $10 million at death and his lifetime exemption is $12.06 million. John's estate owes no estate taxes because his net worth is less than his lifetime exemption.

Example 2. John gives a single gift of $1 million to Daughter while alive and counts it toward his lifetime exemption. John's net worth at death is $10 million. The gift to Daughter was $984,000 over the $16,000 annual exclusion, which reduces his $12.06 million lifetime exemption by that amount to $11.076 million. John's net worth of $10 million at death is still less than his remaining lifetime exemption, so his estate will owe no estate taxes. The $1 million gift to Daughter was essentially a free gift because his net worth remained under the lifetime exemption.

Example 3. Same scenario as Scenario 2, but John dies with a net worth of $12 million. After the gift to Daughter, John's remaining estate tax exemption is $11.076 million. Now his net worth exceeds his remaining lifetime exemption by $924,000, so John's estate will owe federal estate taxes on that amount. John's large gift in this scenario had federal estate tax implications. Had he given Daughter the $1 million in smaller gifts to Daughter and her family over the years, John could have reduced the amount of

EFFECT OF GIFTING ON TAX BASIS

An asset's tax basis is generally the purchase price or its value when inherited, less depreciation taken. For example, a tractor purchased for $100,000 with $60,000 depreciation taken has a tax basis of $40,000 remaining.

The tax basis of an asset has significant tax implications. The higher the tax basis, the more depreciation can be taken and the less taxes owed when sold. Using the above example, if the tractor is sold for $70,000, the $40,000 tax basis is not taxed, only the $30,000 gain (sale price – tax basis) is taxed. The higher the tax basis, the less taxes are upon sale.

As noted above, the tax basis is usually established at time of purchase or inheritance. This is known as a "step-up" in tax basis because the tax basis is stepped-up to either the purchase price upon purchase or the fair market value upon death of the owner. This step-up in tax basis is particularly important when an asset is inherited because **when an asset is gifted, a step-up in basis does not occur**. For estates with no estate tax liability, an inherited asset with no estate tax also receives a full stepped-up tax basis. The person inheriting can re-depreciate the asset or sell the asset and pay no taxes on the sale, if sold for no more than the stepped-up tax basis. **Consider another example**:

> Bill inherited the tractor above from his father's estate. Prior to his father's death, the tractor had a tax basis of $40,000. The tractor appraised for $80,000 at the time of father's death, so Bill receives the tractor with a stepped-up tax basis of $80,000. Bill can either depreciate the tractor and offset $80,000 of income or sell the tractor for $80,000 and pay no tax on the sale. If Bill's father would have gifted the tractor to Bill during life, Bill would have received it with the lower $40,000 basis. From a tax perspective, Bill was better off inheriting the tractor rather than being gifted the tractor.

As these examples show, there can be negative consequences to gifting assets. Before gifting an asset, be sure to analyze all the tax implications of the gift. You may find that passing the asset by updating your estate plan is a better strategy for your heirs.

USING GIFTING STRATEGIES IN A FARM TRANSITION AND ESTATE PLAN

While gifting is not always the best tax strategy for farm transition plans, there are times when its advantages outweigh the loss of a step-up in tax basis. Gifting can be, and often is, an important part of a plan. The following scenarios illustrate situations where gifting can be a good option:

Transferring a depreciating asset. Sometimes the older generation owns machinery, equipment, livestock, or other assets that will lose value over time. Owning these types of assets also carries with them some degree of liability exposure. If an owner does not need income from the assets, it can make sense to transfer the assets now rather than upon death. In this situation, transferring the assets during life to remove the challenges of ownership outweighs the lost step-up in tax basis.

Gifting appreciating assets. For people who are close to or over the estate tax exemption, gifting appreciating assets can be a good strategy. If the asset is gifted now, the future appreciation of the asset is transferred out of the giver's estate. For example, a farm is gifted that is worth $1 million today but is expected to have a significant increase in value. When the value of the farm doubles, the additional $1 million in appreciation occurs in the giftee's estate rather than the giver's estate. The gift causes a loss of a stepped-up tax basis, but it is probably well worth it to avoid a 40% estate tax on the $1 million appreciation.

REVIEW GIFTING WITH YOUR LEGAL AND TAX PROFESSIONALS

Gifting can be a good tool to help build a farm transition plan, but sometimes it should be left in the toolbox. Be sure to have a discussion with your attorney and tax advisor before making any significant gifts. A thorough analysis can reveal tax implications for both you and the person receiving the gift.

REFERENCES

26 U.S. Code Subtitle B Chapter 12, Gift tax https://www.law.cornell.edu/uscode/text/26/subtitle-B

26 U.S. Code Subtitle A Chapter 11, Estate tax
https://www.law.cornell.edu/uscode/text/26/subtitle-B/chapter-11

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