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Tax Issues for Asset Transfers

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About the Instructor

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She began her career as a California CPA, and later worked for the USDA.

She holds a Juris Doctor with a certificate in Food and Agricultural Law from Drake University Law School, and a BS in Agricultural Economics from the University of California at Davis.



Overview

1. Types of Transfers
2. Types of Tax Issues Associated with Transfers
3. Basis
4. Gain (or Loss)
5. Planning Implications



Types of Asset Transfers



Types of Transfers

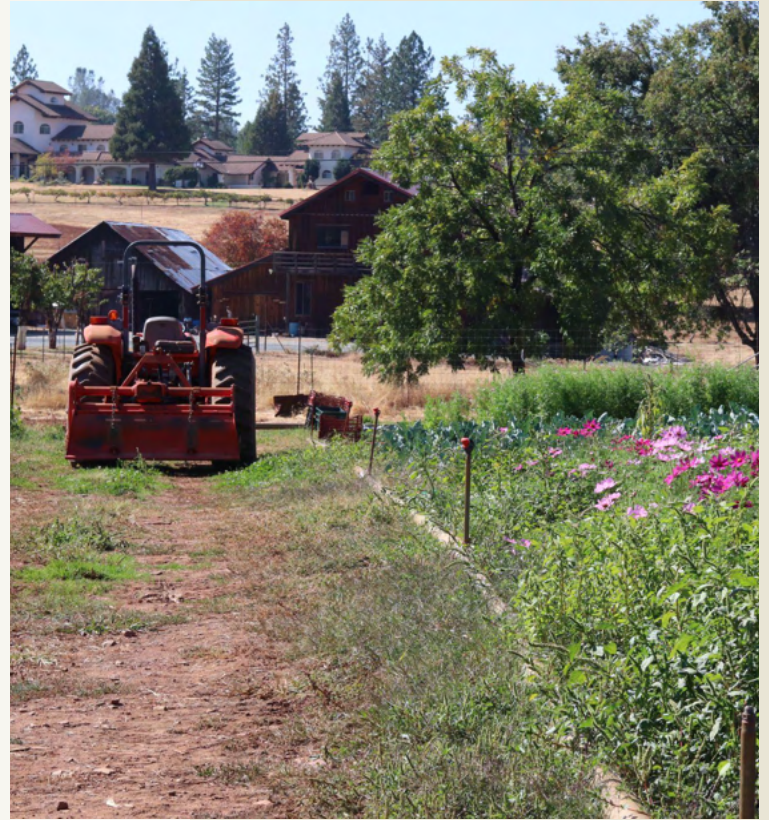
1. Gift / Grant
2. Sale
3. Inheritance

A gift is typically made in the context of a personal relationship. Key words are “love” and “affection.”

A grant is typically made by a government agency or a nonprofit organization. Key words are “merit” and “charitable purpose”.



Types of Tax Issues with Asset Transfers



Assets

- Business assets benefit a business over multiple years.
- The IRS has different rules for assets depending on the nature of the asset and how it is used.
 - Affects what may be deducted when.
 - Affects tax treatment of income or loss when asset is transferred.



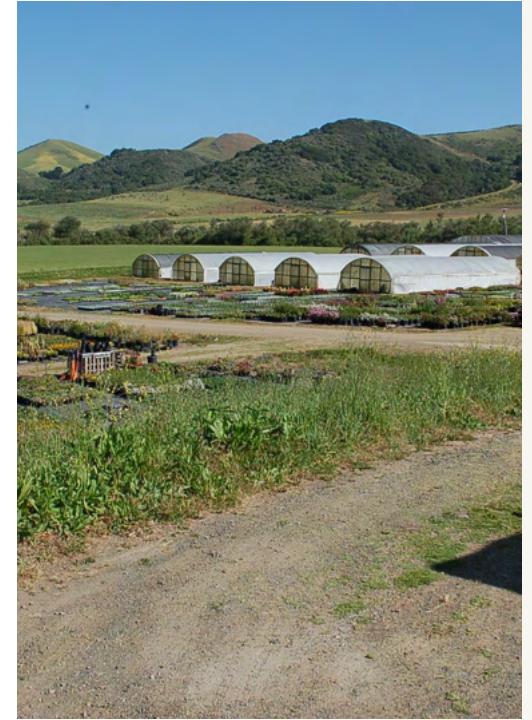
Tax Issues Associated with Asset Transfers

1. Income Tax
2. Capital Gains Tax
3. Sales Tax
4. Estate and Inheritance Taxes
5. New tax basis for new owner
 - Income tax if earned in the ordinary course of business
 - Capital gains tax for the sale of a capital asset
 - Sales tax depending on state law
 - Estate or inheritance tax if above federal or state limits
 - New depreciable basis and state property tax basis for new owner



Tax Issues Associated with Asset Transfers

Before we discuss how to understand and plan for these issues, we need to understand the concepts of basis and gain.



What is Basis?



Assets and Depreciation

- Business assets must be “capitalized.” Capitalized is a tax and accounting term that means “treat as a long term asset, not as a current expense.”
- Business assets are **depreciable** if they have **an ascertainable life** - that’s IRS for: “we can ascertain that one day it won’t exist.”
- If an asset is depreciable, then a portion of the asset’s value may be deducted each year as a **depreciation deduction**.
- The amount of the depreciation deduction depends on:
 - The the IRS-determined **life**
 - The depreciation **method** selected by the taxpayer from among the IRS allowable methods.
- A taxpayer may choose different methods for different assets but for each asset once the depreciation method is chosen it cannot be changed.

Basis

Basis is the value of the owner's investment in an asset.

- Accounting basis is determined according to Generally Accepted Accounting Principles (GAAP)
- Tax basis is determined according to the governing tax law
 - Internal Revenue Code for Federal Taxes
 - State Income Tax & Estate Tax Code for State Taxes
 - State Property Tax Code for Property Taxes



Original Basis

1. Cost Basis
 - Purchase Price
 - Cost to Build/Construct/Create
2. Gift Basis
 - Tax basis of donor
3. Stepped-up Basis
 - Fair Market Value at Date of Death or Six Months After

An owner may have any of these types of basis in an asset.



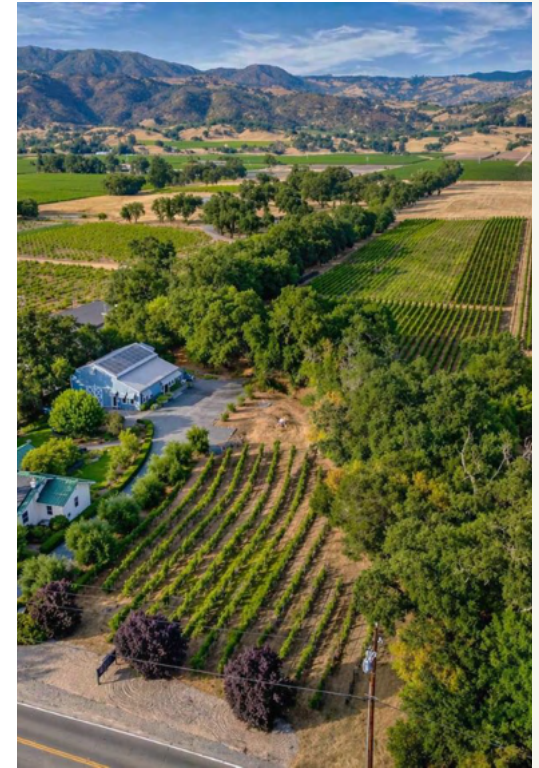
Reductions to Income Tax Basis

- For Federal income taxes, an owner's basis in an asset is reduced by the total cumulative amount of **depreciation deductions** the owner **took - or was allowed to take** - on their federal income tax returns.
- If an owner did not take a depreciation deduction that was allowed, their basis in an asset will be reduced anyway, as if they had taken the allowable deductions.
- State income taxes are generally similar to federal income tax rules, but there are important differences. Taxpayers in states with income tax typically have depreciation schedules showing basis and depreciation for each asset under federal and state rules.

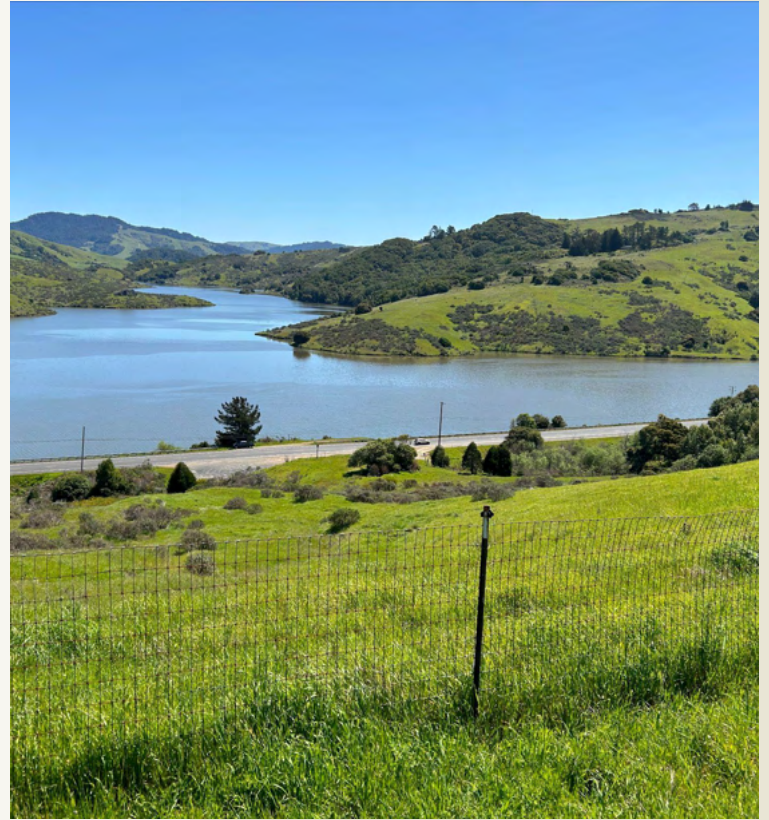


Increases to Property Tax Basis

- Federal income tax basis in assets generally goes down with depreciation.
- State property tax basis may go up or down depending on how the property is reassessed by the local taxing authority.
- New improvements (buildings, etc.) get a new federal tax basis and may also result in an increased local property tax basis.



What is Gain (or Loss)?



What is Gain (or Loss)?

Gain or loss is sales price less basis.

	<u>Gain</u>	<u>Loss</u>
Sales Price	\$10,000	\$ 1,000
Less Basis*	<u>(3,000)</u>	<u>(3,000)</u>
Equals Gain/(Loss)	7,000	(2,000)

*Basis

Original cost basis (typically purchase price)	\$ 20,000
Less: Total Accumulated Depreciation	<u>(17,000)</u>
Equals Basis	3,000



Capital Gains Taxes

- For Federal Income Tax purposes income from capital gains (sale of capital assets) is taxed at a different rate than income from ordinary business activities or from interest and dividends.
- Losses from sales of capital assets are also subject to different rules about how they can be used to offset other income.
- **The federal tax rules for capital gains and losses also depend on if the subject property was used in a business or if it was held for investment or personal use.**
- State income tax rules vary.



Tax Planning for Asset Transfers



Ordinary and Specialized Tax Planning

- Regular income tax is calculated on sales in the ordinary course of business.
- Capital gains tax is calculated on sales of assets.
- Sales tax, estate and inheritance taxes, and changes in property taxes are all special tax issues not in the ordinary course of business.
- Ordinary income tax planning addresses how to minimize income taxes on ordinary income, for a typical year.
- When asset transfers are involved taxpayers need to do additional tax planning to account for capital gains tax, sales tax, estate and inheritance tax and changes in property tax basis.
- When negotiating the sale or purchase of a business, or significant business assets understanding the tax implications of different aspects of the sale can make it easier to benefit both parties.

Income Tax Planning with Business Transfer

- A sale of a business often includes a contract for the former owner to act as an adviser in the new business.
- This maintains continuity, and if the prior owner is financing the sale they are highly motivated to ensure the continued success of the business so they can get paid.
- **For tax purposes this arrangement is not connected to the transfer of the asset (sale of business).**
 - It creates ordinary income (not capital gains income) to the prior owner and ordinary expense to the new owner.
 - Sums paid for advising are not subject to sales tax, and are expensed immediately rather than depreciated.

Capital Gains Tax Planning Generally

- Selling highly appreciated assets, like a business or land, raises complex tax planning considerations.
- Generally an owner who sells an asset wants to avoid capital gains tax, but would rather pay capital gains tax than income tax because the tax rate on capital gains is lower than on ordinary income.
- But there are many individual circumstances that would change this equation and cause the seller to prefer ordinary income (or loss) to capital gains income (or loss).

Sales and Income Tax Planning with Sale of Business

- In jurisdictions with sales tax, equipment included in a business sale may be taxable, making purchase price allocation a complex and important issue.
 - Sellers often prefer allocating less value to equipment and more to non-taxable assets like land and intangibles to reduce sales tax liability.
 - Buyers often prefer higher allocations to equipment for immediate depreciation benefits and lower allocations to non-depreciable land.
- The allocation of the sales price can be important in negotiating the details of the sale. The same total sales price can have a different effect depending on how it is allocated.
- Taxing authorities may contest how the sales price is allocated. An appraisal conducted by a qualified appraiser is the best evidence to support the allocation and the associated tax treatment.

Estate and Inheritance Tax Planning Generally

There are three issues in transferring assets through an estate plan:

1. Federal estate tax
2. State estate and inheritance taxes (12 states and DC only)
3. Stepped-up basis in inherited assets

The first two issues only affect some, mostly larger, estates.

Stepped up basis affects all estates.



Federal Estate Tax Planning

- There is no federal estate tax for estates under the estate tax exemption amount.
- **The exemption amount has varied over time:**
 - **Pre-2017:** Approximately **\$5 million per person**
 - **2017-2025:** Increased to around **\$14 million per person** (subject to inflation adjustments)
 - **2026 and beyond:** **\$15 million per person** (subject to inflation adjustments)



Planning for Stepped-Up Basis

- Most estates are exempt from federal estate tax, but stepped-up basis affects all heirs regardless of estate size.
- An heir receives property through inheritance, meaning after the prior owner's death, not as a sale or gift during the life of the prior owner.
- The heir's tax basis in the inherited property is "stepped up" (increased) to its **fair market value at the date of death (or six months later)**. This means an heir can sell the property shortly after inheriting and pay no taxes (basis will be the same as sales price), but if the parent sells the asset to the child the parent will owe capital gains tax (current sales price will exceed old basis).
- This prejudices a family against transferring assets to the next generation through any method other than inheritance, because transfer through inheritance is the only way to avoid capital gains tax.
- **For most farm succession plans, capital gains tax is often a greater concern than estate tax.**

State Estate and Inheritance Taxes

Estate Taxes

- Imposed by **CT, HI, IL, IA, KY, ME, MD, MA, MN, NE, NJ, NY, OR, PA, RI, VT, WA**, and the **District of Columbia**.
- Paid by the estate, calculated as a percentage of the estate's value after deducting a state exemption amount.
- Exemption amounts vary widely, from \$0 to several million dollars.
- Tax rates range from 1% to 20%.

Inheritance Taxes

- Imposed by **IA, KY, MD, NE, NJ**, and **PA**.
- Paid by the individual receiving the inheritance.
- Close relatives often qualify for exemptions or lower tax rates.
- Rates vary from 0% to 16%, based on the value of the inherited property.

Planning for Stepped Up Basis

Stepped up basis is good for heirs in two ways:

1. They can sell the asset immediately and not owe any capital gains tax.
2. If they want to continue using the asset in their farm or ranch business they can start depreciation all over again for federal tax purposes.

Example: A barn built in 1970 for \$15,000 and used in the farm owned by G. G's basis in the barn is zero, the full \$15,000 was deducted as depreciation expense between 1970 and 2010. X inherits the barn, and it is appraised at \$100,000 based on the cost to re-build. X may depreciate the \$100,000 over the next 40 years.



But – State and Local Property Taxes!

- Generally inherited property is not subject to an immediate re-assessment of the property value, particularly not for a primary residence.
- Business property is more likely to face reassessment after inheritance.
- Farm or ranch property may be subject to special rules.

When planning any transfer, the new owner must: understand the estimated state and local property taxes on the inherited asset and ensure they have sufficient income to cover these annual taxes.

For marginally profitable farms or ranches in high property tax areas this may be a significant issue.

California Property Taxes and Inheritance

In CA inherited property is reassessed subject to the following:

1. **Family home exemption:** if the child-heir moves into the parent's primary residence within one year of the death of the parent. Limited exemption also for grandparent-grandchild inheritance.
2. **Family farm exemption:** farm and ranch property will not be reassessed if the child-heir continues to use the property for the production of plants and animals for sale (***watch out for agri-tourism and value-added facilities!***)
3. **Limits for both exemptions:** If the difference is more than \$1M there is a new assessment on the portion above \$1M.

Additional Resources



Additional Resources

1. [IRS Publication 225 - The Farmer's Tax Guide](#)
2. [IRS Publication 551 - Basis of Assets](#)
3. [RuralTax.org](#)
4. [Center for Agricultural Law and Taxation at Iowa State](#)
5. [California FarmLink's Tax Toolshed](#)
6. [Agricultural Finance, Tax and Asset Protection Program from the Southern Extension Risk Management Education Center](#)
7. [California Board of Equalization Prop 19 Fact Sheet](#)





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Questions?





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Thank you!

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