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A Word from the Editorial Committee

This issue of the Ag Law Update is shorter than our usual issue, but addresses concerns that impact everyone in agriculture. Thanks to our guest editor, Patrick Costello, for putting together a wonderful issue. The lead article, by Michael P. Sampson, ponders the future of basis adjustments. The "step-up" in basis at death has formed the centerpiece of many estate plans, particularly those of owners of agricultural land. The step-up also figures prominently in succession planning. With discussions of eliminating the basis step-up, the article is timely and informative.

Robert Moore discusses possible federal income tax and estate tax changes in the second article in this Ag Law Update. In addition to the elimination of the basis step-up, like-kind exchanges and the federal estate and gift tax exemption may see changes. Any of these changes would require agricultural lawyers to be ready to act to protect their clients. The final article in this edition discusses the students employed at the National Agricultural Law Center through their fellows program.

We look forward to seeing you at the American Agricultural Law Association Annual Symposium in Salt Lake City in November. Our next Ag Law Update will include articles on the highlights of that event. We are always looking for ideas for themes or articles for the Update. If you have an idea or an article, please contact one of the editors.

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Feature Articles: Estate & Succession Planning

As guest editor of this Update on farm and ranch succession, I am introducing you to Michael Sampson. Mike and I are natives of Lakefield, Minnesota - when he was eight years old, I knew his intellect would take him places. Little could I imagine it would be the intellectual pursuit of estate and gift tax law, always one of my favorite subjects. Following Mike's article on "Pondering the Future of Basis Adjustments" is an article by our AALA colleague Robert Moore on addressing client apprehension as changes in tax law are debated in the halls of Congress.

Federal estate and gift tax laws have been the tail that waged the dog in the realm of farm succession planning for as many decades as anyone living can remember. In all but a few states, a farm couple can now pass $23.4 million without estate tax. The exemptions are so high the IRS has been collecting estate tax on fewer than one hundred farm estates per year. Estate tax revenue pales compared to the revenue from taxing capital gains at death. A farm estate paying capital gain income tax could become the rule rather than the exception under proposals discussed in the Administration and Congress. We have become accustomed to two features of tax law: "adjustment of basis" at death and ample estate tax exemptions.

The upward trend in the estate tax exemption has ended even if nothing changes because the current law lowers the exemption to $5 million (adjusted for inflations $6 - $7 million) by 2026. Farms are bigger, and land prices continue to rise. Contemplation of death without a "step-up" in basis is foreign.

To raise taxes, Congress will need to decide on its definition of "wealthy" to target the rich. Will there be special agricultural use basis rules? Hold on tight; we will soon see where this goes.

Pondering the Future of Basis Adjustments

Michael P. Sampson

Michael P. Sampson is an estate planning and tax attorney at the Minneapolis-based law firm Maslon LLP. He is a frequent speaker and author of articles on estate planning and tax-related topics and also serves as an adjunct professor of Wills & Trusts and Estate & Gift Taxes at Mitchell-Hamline School of Law in St. Paul, Minnesota.

President Biden, in a recent nationally-televised address, discussed his American Families Plan and outlined his administration's policy priorities—including, among other things, how he proposes to pay for the spending proposals included in the Plan.

For many of us who work with clients on succession and transition planning, that major changes to the federal estate and gift taxes (a reduction in the amount of the exemption, an increase in tax rates, or both) were not on the list of tax law changes called for by his Plan came as something of a surprise ,though changes to the estate and gift tax laws are included in a separate bill introduced in the Senate by Bernie Sanders called the "For the 99.5% Act," S. 994.

Instead, the revenue side of the American Families Plan appears to focus mainly on changes to the income tax, including the capital gains tax—perhaps because these changes might actually have a meaningful near-term effect on revenue. The federal transfer taxes are not traditionally viewed as great sources of revenue and are often said to be primarily policy taxes, ostensibly seeking to prevent the accumulation of large fortunes and to curtail the outsized political and social power that goes along with them.

The Proposed Changes in the American Families Plan

One of the proposed changes in the Plan is to expand the application of the 3.8% tax on net investment income (sometimes called the Obamacare Surtax) to all unearned income. It currently applies to unearned income for those taxpayers with modified adjusted gross income in excess of $250,000. This proposed change is of less immediate significance to those whose income is derived from an active trade or business, a group that includes materially participating farmers. Cash rent landlords would be faced with this additional tax.

Other proposed income tax changes would not affect many in farming businesses. However, one proposal forms the subject of the rest of this paper.

The changes with the broadest potential application to agriculture are the proposals related to capital gains taxes. These changes *will* affect individuals who are actively involved in an active trade or business, especially in agriculture because it involves significant capital assets. Of particular interest in this context are the proposed elimination of the basis adjustment at death under Internal Revenue Code Section 1014 and the addition of a requirement that capital gains be recognized on certain gratuitous transfers, including lifetime gifts and transfers at death.

What is Basis?

In order to understand why the elimination of the Section 1014 basis adjustment and the treatment of gratuitous transfers as deemed recognition events could have an outsized impact on family farms, it might be worth spending a few minutes on the subject of basis itself. Here's how I think about basis and explain it to client): for capital assets (that is, assets purchased for the purpose of generating future income, appreciation, or both), basis is the way the tax code keeps track of portion of the asset's value that has already been taxed so that you can calculate the portion of the value that has *not* or not yet been taxed.

For example, when you use after-tax dollars to purchase an asset, the purchase price becomes your basis in that asset--

this is the cost basis rule of Section 1012. Upon a sale or other disposition of a capital asset for an amount that exceeds your basis, you realize and must typically recognize a capital gain. Similarly, upon a sale or other disposition of a capital asset for an amount that is *less* that your basis, you realize a capital loss, which can be netted against capital gains recognized in the same tax year or carried forward to be netted against capital gains recognized in the future.

Not all realized capital gains must be recognized. Many non-recognition rules in the tax code exist. For example, when you exchange a capital asset for another asset of like-kind, Section 1031 provides that, even if the value of the asset you receive in the exchange is greater than your basis, you do not have to recognize gain unless you receive cash as a part of the deal. In that case, you only get basis credit for the after-tax dollars you invested in the original asset.

Similarly, when you contribute after-tax dollars to a corporation in exchange for stock in the company, the amount you contribute becomes your basis in the shares. If you contribute appreciated property to a corporation in exchange for stock, Section 351(a) says you do not have to recognize gain at the time of the contribution, even if the value of the stock you receive is higher than your basis. As above, your basis in the shares will be limited to your basis in the contributed property. It is often said that your basis in the original asset carries over to the new asset in non-recognition transactions, which is why it is typically called "carry-over basis."

As a general rule, whenever you have a non-recognition transaction (whether it is a contribution to a corporation, a partnership, or an LLC in exchange for an ownership interest in the entity, or a transfer to an individual or a trust that is treated as a taxable gift), your basis in the asset you receive in the exchange, or the basis of the transferee in the case of a gift, will almost always be equal to the basis in the asset transferred.

One major exception to this general rule is the basis adjustment rule of Section 1014 (as presently in effect). This rule is often referred to as the "step-up in basis," though it can be a step-down as well, especially in a period shortly after a severe market downturn. Under this rule, when an asset passes from a decedent to another at the time of the decedent's death, as long as the asset is included in the decedent's estate under Chapter 11 of the Code (more on that in a minute), the asset will receive a new basis equal to the value of the asset for estate tax purposes. Section 1015 includes a similar basis adjustment for gift taxes paid on lifetime transfers subject to the tax under Chapter 12, and Section 2654 allows for a basis adjustment for generation-skipping transfer taxes paid on transfers subject to the tax under Chapter 13.

With most of the other non-recognition transfers, the recognition of gain is not *avoided* but is simply deferred until a later date—typically when the asset is sold for cash or property that is not of a like kind. Section 1014 and the similar rules under Section 1015 and 2654 differ in that some or all of the appreciation in the value of the transferred asset (the unrecognized gain) is never taxed at all. Those receiving the benefit of a basis adjustment now have a new basis for purposes of calculating taxes on future dispositions that is not related to any income taxes paid on the transfer. In that sense, the adjustment to basis and, specifically, the upward adjustment typically called the step-up in basis is a significant tax benefit for beneficiaries who receive appreciated assets from a decedent at the time of the decedent's death.

Why Adjust the Basis at Death?

One often-cited rationale for the basis adjustment for assets transferred at death is that it serves as a partial off-set for the estate taxes that must be paid when those assets are transferred. There are at least two problems with this argument: first, the income tax and the estate tax are completely separate tax regimes intended to tax different things. The income tax is intended to tax accretions to wealth, while the estate tax is intended to tax the privilege of transferring accumulated wealth to others. Because the taxes are targeting different things, no connection exists between the two.

Second, the basis adjustment under Section 1014 applies whether or not estate tax is actually paid by the decedent's estate. What is required is simply that the assets be included in the decedent's estate under the rules of the tax code). Today, with the federal estate tax exemption at $11.7 million per taxpayer, or $23.4 million for a married couple, the idea that the basis adjustment for assets passing at death is intended to off-set the estate taxes paid to transfer those assets is simply not true for the vast majority of decedents.

Why, then, does the tax code allow for these adjustments to basis? I posit two possible reasons. The first is that the basis step-up keeps assets in circulation—or, as an economist might say, supports the free market's desire to allocate capital to its highest and best use. The recognition of capital gains taxes on the sale or disposition of appreciated assets causes many people to hold on to those assets when they might otherwise prefer to sell them and invest the capital in other things. The rules on like-kind exchanges mitigate this somewhat, but those rules do not apply to securities. In my experience, beneficiaries commonly liquidate assets that have experienced significant appreciation shortly after a decedent's death. Without an upward adjustment to basis, these appreciated assets likely would not be sold and the capital would continue to be frozen in place. As we will see in a minute, this result is not always undesirable from the perspective of the transferor.

The second reason is far more practical: the adjustment to the basis of inherited assets simplifies record-keeping by giving the new owners of inherited assets a clear idea of their basis in the assets. This record-keeping problem is discussed every time the idea of repealing the basis adjustment in Section 1014 is proposed and, I believe, is a key reason why all previous attempts to eliminate the basis adjustment at death have failed. How do you figure out what your basis is? Many people don't keep track of that information (or perhaps they do, but the information is in their heads and dies with them). Clients and their tax advisors must often resort to forensic accounting to calculate an individual's basis in long-held capital assets. Under current law, we get to hit the reset button on basis at least once per generation, which makes things easier on taxpayers and, I assume, the Internal Revenue Service as well.

The reason President Biden and members of Congress are looking at the basis adjustment rules is that they know these rules, though popular, result in a lot of foregone revenue. Multi-trillion

dollar stimulus plans and infrastructure programs have to be paid for somehow.

Deemed Recognition of Gain at Death

Eliminating the basis adjustment at death, by itself, will not necessarily allow the government to capture this revenue. As noted above, the prospect of recognizing capital gains and paying taxes to free up capital often causes taxpayers to hold onto assets. Without the basis adjustment, the untaxed gains are not eliminated, but many of them may simply continue to be deferred—in some cases indefinitely. In addition, if capital gains rates are increased, the incentive to hold appreciated assets becomes even stronger.

For that reason, the current proposals call for not only eliminating the basis adjustment at death but also requiring taxpayers to recognize gains on assets transferred at death. This recognition of gains at death tap into the potential revenue that is locked inside of appreciated assets when they pass from one generation to the next. In addition and perhaps not coincidentally, this approach allows the government to raise tax rates on capital gains in the bargain because you have no choice about whether to recognize the gains or not.

I often tell clients that the basis adjustment matters most to your heirs if they plan to sell an asset in the future. For investors who hold significant commercial real estate, a basis adjustment also allows for potential depreciation. However, if you intend to hold an asset indefinitely—particularly an asset, like land, that cannot be depreciated—you may not benefit as greatly from the basis adjustment at death.

This idea seems to have particular appeal for the owners of family businesses—especially family farms. If there is any concern that the next generation's enthusiasm for the farming business might wane (particularly when mom and dad are gone), the idea that the kids can't sell the farm without triggering capital gains can be viewed as an incentive to keep the farm in the family and, possibly, to keep the family on the farm. This is one reason some clients choose to transfer their assets by gift (or by means of a sale to an intentionally-defective grantor trusts) rather than at death.

For family-owned businesses—and family farms in particular—repealing the basis adjustment at death, by itself, might not be so bad. If you are not going to sell (and you're never going to sell, right kids?), you don't have to care so much about basis and you might say the lower, the better.

It's the second part of the proposal—the forced recognition of capital gains at death—that could be extremely problematic for farmers and ranchers. This change in the law will force the families that own these businesses to recognize gain on all appreciation at each generation. Heirs experience the pain of paying the tax without realizing the cash with which to pay the tax liability. For some family businesses, particularly those who hope to keep a business in the family, forced recognition of gain at death represents the worst possible outcome.

Is Deemed Recognition of Gain Politically Feasible?

Many Americans hold the vast majority of their wealth in their retirement accounts and their homes. Retirement accounts, which are treated as income in respect of a decedent, or IRD), do not get the benefit of the basis adjustment under Section 1014 under current law. Similarly, individuals are permitted to avoid up to $250,000 of gain or $500,000 for married couples on the sale of their primary residence. These two factors suggest that the vast majority of people would not be affected by the elimination of the basis adjustment at death. If the rules also allow for a certain amount of these deemed gains to be avoided at death—recent proposals include an exemption of $1,000,000 per taxpayer—forcing the recognition of capital gains on appreciated assets at death will not affect most taxpayers at all. In this way, the tax increases can be described as a tax on the wealthy—"regular" people will not be affected.

As anyone who works with farm families knows, getting to $1,000,000 of value is not terribly difficult. For example, at upward of $10,000 per acre for prime Midwest farmland, a family farm with just one Quarter Section of land would be worth more than $1,600,000—and this total does not include the value of the farmstead or any equipment. If this land was purchased (or inherited) in the middle of the 20th century a large portion of this value could be taxable gain. The written summary of American Families Plan says that the Plan would protect "small family farms" by including an exemption for the first $1,000,000 of gain—but as this common example reveals, the emphasis is on *small*.

The example above also highlights the other serious problem with the capital gains tax as it exists today: under the current rules, basis is not adjusted for inflation. That means taxpayers must pay capital gains tax not only on the increase in the value of a capital asset caused by the appreciation of the asset itself but also on the devaluation of the currency that is the basis (pardon the pun) for calculating the amount of the taxable gain. If an asset appreciates at an average annual rate of 7% but inflation is 3% during that same period, the real rate of appreciation is only 4%; nevertheless, under current law, a taxpayer who sells an appreciated capital asset must recognize *all* of the appreciation, including the part that is the result of inflation, as taxable gain.

One could argue that this effect is mitigated by the fact that the tax rate on recognized capital gains is lower than the rate on ordinary income, which is generally taxed in the same year that it is earned). Perhaps that is true. However, if capital gains rates are increased to the same rates as ordinary income—as proposed in the American Families Plan—this mitigation effect would no longer exist.

In the end, family farms may get caught in the political crossfire because land prices are relatively high while commodity prices are uncertain and fluctuate and, as the name implies, are largely out of the farmer's control). Tax policy that seeks to tax the "wealthy" in order to gain political cover could end up inadvertently taxing farmers and ranchers who may not have the means of paying the tax out of future income—even with a 15-year 6166-type deferral—and who may be forced to sell land in order to pay a tax that is not really aimed at them in the first place.

What Can Be Done to Help Farm Families?

In order to mitigate these concerns, a modified capital gains tax regime that would be fair to family farms should

incorporate one or more of these features:

1. The ability to adjust basis for inflation when calculating recognized capital gain.
2. Recognition of the fact that family farms are not as likely to be sold—even with an upward adjustment to basis—as other types of inherited assets and should therefore be treated differently for tax purposes by means of a special use rule akin to Section 2032A for estate tax purposes that would apply to family farms and other closely-held family businesses.
3. The ability to elect to defer the recognition of capital gains at death—that is, to opt into carry-over basis—for as long as the asset remains in family ownership. In this way, the gain on these assets would need to be recognized only if and when the inherited assets are sold. This rule would leave the owners of these family assets with the challenge of figuring out their basis but would apply to a small number of taxpayers.

In the final analysis politicians and policy makers should remember that farming is a unique business and that the rules that make sense for taxpayers with large portfolios of marketable securities or commercial real estate holdings do not always make sense when applied farmers. Because of this, sound tax policy that values the contributions made by family-owned businesses—and, specifically, family farms—should take these differences into account. Otherwise, family-owned farms may become a thing of the past.

Worse, if farm families are forced to pay a significant tax on built-in capital gains when they inherit the family farm, they may have no choice but to sell the land to a third party owner (an investment fund or a REIT) and lease the land back at a rate that is calculated to give the investors a reasonable return on their capital, which may not have any correlation to the revenues farmers are able to generate in the markets where they sell their products. This outcome may be limited somewhat by the (anti-) corporate farm laws in effect in many farm states but could also be a catalyst for these rules to be overturned or eliminated. While the future of the basis adjustment and the avoidance of untaxed capital gains is uncertain, the one thing that is certain is that the proposed changes to these rules could have a profound impact on farmers and the farming industry.

What Tax Changes Can We Expect, If Any?

Robert Moore

For attorneys working with farm clients, the most common question the last six months has been: "What's Biden going to do with taxes?" The question is sometimes asked in the context of subtle curiosity and sometimes the question is asked in anticipation of draconian tax changes. Regardless of the level of concern, our clients expect an informed and substantive answer. The following is a discussion of how we might do our best to answer the tax question.

First, a brief refresher course in civics is sometimes helpful for the client. Many people are under the impression that a President can unilaterally change tax law or use Executive Orders to affect taxes. An explanation that only Congress can change tax law can quickly help alleviate at least some of the client's concern. The President, as leader of the Democratic Party, can provide his proposal for tax changes but he has no legal authority to implement such changes. This discussion leads nicely into a complementary discussion about Congress and tax changes.

The conversation regarding Congress will be more about politics and less about civics. Due to social media and cable news, too many people think all Democrats are crazy left-wing socialists or all Republicans are far-right zealots. The fact is there are many moderate Democrats and moderate Republicans in Congress. The Democrats only have a five-seat majority in the House and will require almost every vote to pass any new tax legislation. New tax legislation that includes large tax increases for farmers and businesses would likely cause at least five defections from the Democrat voting caucus.

The Senate is not so straightforward. Most votes in the Senate require 60 votes due to filibuster rules. It would seem very unlikely that ten Republicans would vote for an increase in taxes of any kind. Some legislation related to the budget can be passed through reconciliation with only a majority vote. Even a majority will be a challenge in the Senate. So far, the two most moderate Democrat Senators seem to be Senator Manchin and Senator Sinema, both of whom have a record of voting with Republicans. Add in the moderate Democrat Senators from Montana, Minnesota, Colorado and Pennsylvania and major increases in taxes seem less and less likely.

While big changes seem remote, it is likely that some tax changes, in some form, will be passed by Congress. Most political analysts seem to think October is a reasonable guess as to when it might occur. The next question becomes, will we have time to react to any changes?

Historically, changes in tax law have not been retroactive. The last time tax changes were made retroactive the Democrats held a much larger majority in Congress. Also, it is very late in the year to make retroactive tax changes. Many farms, businesses and individuals have made major decisions based on current tax law and would be unfairly prejudiced by retroactively enforced tax laws. It is unlikely that tax legislation will be made retroactive to January 1, 2021.

Any tax changes could take effect as of the date of the legislation being passed. However, this would be an enormous burden for the IRS. New tax forms would need prepared for the portion of the year for which the new tax law applied. For example, if the tax legislation was passed

and took effect on October 1, 2021, the IRS would need two sets of forms for tax returns. One set through September 30 and another set beginning October 1. A split year for tax law would also be very challenging for accountants and tax attorneys.

For these reasons, the most likely date that new tax legislation would take effect is January 1, 2022. Therefore, we will likely have some time between tax legislation passing and that legislation going into effect to implement strategies to help our clients.

After discussing the President's inability to pass legislation, the challenge of passing new tax legislation through Congress and any changes not likely taking effect until next year, most clients will understand that the currently proposed Biden tax legislation is likely not as great a threat as they first thought. So, the best answer to the Biden tax question might be: "No one knows, let's watch and see. It probably won't be as bad as some commentators are making it but there will probably be some changes. Most likely we will have time to implement strategies to address any changes before they take effect."

While the current Biden tax proposal is not likely to be passed in its current form, it is good to know what is being proposed. The following are some of the proposed provisions that would have the biggest impact on farm clients:

1. The estate tax would essentially be reduced to $1 million/person. "Certain family-owned and operated businesses" would be exempt from an estate tax. While this exemption is not specifically defined it would likely include farming assets used by the heirs to continue the farming operation. This low estate tax exemption would affect many people and many businesses and could be devastating to continuing family-owned farms and businesses.
2. Like Kind Exchanges (Section 1031) would be eliminated. Many farmers have expanded their land base by selling high value land and reinvesting the money in areas where farmland has less development value, thus increasing their land base. Up to $500,000 could be deferred each year so smaller exchanges could still work to some degree. The elimination of like kind exchanges could cause a decrease in farmland values as owners would be more reluctant to sell.
3. The step-up in tax basis at death would be repealed. This would be a huge loss for family farms and small business owners. Current law provides that all assets receive a stepped-up basis on inherited assets. The loss of stepped-up basis would cause farm families to pay significantly more in income tax or capital gains tax.

In this time of uncertainty regarding tax changes, the best thing we can do for clients is to stay informed and provide unbiased advice. Part of that advice is to admit that no one knows what will happen but that moderation and compromise will likely win out over sweeping changes. Another part of our advice should be to stay flexible and be ready to act if needed.

At our firm, we have decided to wait and see. We do not expect big changes in the tax law and we do not expect any changes to take effect until January 1, 2022. When we have a more definite idea of what tax laws may look like in 2022 we will begin advising clients on implementing strategies. With that said, we have advised clients that we do not have a crystal ball and that we are just making a best guess. Everyone needs to stay informed and be ready to act quickly if necessary.

Students at Work

Throughout the year, the National Agricultural Law Center employs law students interested in working with the Center through a fellowship program. Research Fellows are an integral part of the NALC team, conducting legal research and writing projects that contribute to the Center's place as the nation's leading source of agricultural and food law research and information. Fellows find themselves working in such areas as environmental regulation of agriculture, food safety and labeling, agricultural finance and credit, and other legal issues for farmers and ranchers.

In the past decade, the NALC has hired research fellows from 25 states and dozens of law schools across the country. Following their fellowship, NALC research fellows have gone on to become successful legal professionals in private practice, policy, and higher education.

One former Research Fellow, Amie Wilcox, was named an Outstanding Pro Bono Attorney of the Year by Legal Aid of Arkansas. After completing her fellowship at the Center and graduating from the University of Arkansas at Little Rock, she went on to join the firm Friday, Eldredge & Clark.

Other fellowship opportunities include the Scott E. Fancher Agricultural Law Research Fellowship, which is focused on agricultural law research activities in the row crop industry. The Fancher Fellowship was created in memory of Scott, an outstanding agricultural lawyer and a former AALA member.

Successful applicants to the research fellow program should have completed at least their first year of law school and have demonstrated skills and experience in legal research and writing. Previous experience or background in agriculture is preferred, but not required. Applicants must be motivated and capable of reliably implementing work projects in a distance-working arrangement.

Applications are accepted in April, July, and November of each year, and are advertised on NALC social media. Find us on Twitter at @nataglaw and on Facebook. Learn more about the NALC and the research fellow program here.

The Agricultural Law Bibliography

We appreciate the ongoing work of Professor Drew Kershen, who each quarter compiles an Agricultural Law Bibliography. The National Agricultural Law Center maintains an archive of all of Drew's Quarterly Updates here. The bibliography made a regular appearance in the long-ago printed version of the Agricultural Law Update, so we've brought it back. The Quarterly Update for the second quarter of 2021 is below.

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