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**INCOME TAX MYTHS,
TRUTHS, AND EXAMPLES
CONCERNING FARM
PROPERTY DISPOSITIONS**

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INCOME TAX MYTHS, TRUTHS, AND EXAMPLES CONCERNING FARM PROPERTY DISPOSITIONS

Introduction

Each year many farm families sell or dispose of some of their farm business assets. Typical sales vary from crops that had been inventoried to dairy cows and breeding livestock. The sales of all livestock, machinery, land, and buildings by farm families are not a common annual occurrence. Most farmers are not fully aware of the income tax consequences of major sales. Many are shocked by the magnitude of their income tax liabilities after they have sold the farm and some do not have the resources to pay them. Sales or dispositions resulting from low profitability, negative returns, and the inability to make payments are extremely difficult for farmers to manage. Additional financial burdens such as income taxes compound the decision making process and add to family stress.

Farm families need to be well informed of the income tax consequences of property disposition so the shock and stress caused by the unexpected tax bills can be avoided. Following are some basic income tax myths, truths, and examples that will enable the farm owner to be better informed of many of the most important income tax management opportunities and rules affecting farm property sales.

Know Your Tax Basis and How To Use It

Myth #1: When farm property is sold, taxable gain is the difference between the sale price and the unrecovered cost of the property recorded in the depreciation schedule.

Truth: The taxable gain is the difference between the sales price (less selling expenses) and the income tax BASIS of the property sold. The BASIS includes, but is not limited to, the unrecovered cost of depreciable property. Knowing and understanding how to determine the basis of property is fundamental to tax planning. BASIS is valuable. The higher the basis, the lower the taxable gain. A record of the cost and basis of all property acquired is needed to determine BASIS when the property is sold.

Rules:

- BASIS of property you bought = cost less depreciation
- BASIS of property you raised = zero
- BASIS of property you inherited = appraised value in estate
- BASIS of property gifted to you = basis in hands of donor

Example: Don Detail sells his raised cows, crops, purchased machinery, and farm real estate for \$750,000. The sale includes: 50 acres of land given to him by his father, the main farm he purchased from his mother, a farm house he inherited from his mother, additional farmland he purchased, and a new barn he constructed. The cost of the sale was \$35,000. The basis and taxable gain on each item are reported on the following page.

Basis and Taxable Gain from Sale

Item	Sale Price	Cost of Sale	Basis	Taxable Gain
Raised crops	\$40,000	\$2,000	\$ 0	\$38,000
Raised cows	160,000	8,000	0	152,000
Machinery	150,000	7,000	63,000	80,000
50 acre gift	45,000	2,000	13,000	30,000
Main farm	150,000	7,000	78,000	65,000
Farm house	80,000	4,000	51,000	25,000
Purchased land	55,000	2,000	33,000	20,000
New barn	<u>70,000</u>	<u>3,000</u>	<u>37,000</u>	<u>30,000</u>
Total	\$750,000	\$35,000	\$275,000	\$440,000

Excluding gain from his house, Don has \$148,000 of ordinary income (crops, machinery, and new barn) and \$267,00 of capital gain income (raised dairy cows, 50 acres, main farm, and purchased land) from the sale of the farm. Federal and New York State income taxes may exceed \$147,000 or 35 percent of taxable gain recognized from the sale. Actual taxes on the sale will depend on sale income and the amount of other income in the year of sale.

Don has excellent records on all property acquired which enables him to determine an accurate basis. All cattle and crops were raised. They have a zero basis because the cost of growing and raising have been or will be deducted on Schedule F. The \$63,000 unrecovered cost or basis for machinery is found on Don's depreciation schedule.

When Don received the gift of land from his father, he recorded its current market value, the \$10,000 price Dad paid for the land in 1954, and \$1,200 for non-depreciable land improvements made in 1960. Dad's basis was \$11,200 and that became Don's basis when the gift was made. Don's records show he spent \$1,800 on hedgerow removal (not expensed) since owning the property. His basis on the 50 acres of land is now \$13,000.

The main farm was purchased for \$100,000, \$50,000 was allocated to land and \$50,000 to depreciable buildings. The \$78,000 of basis includes \$50,000 initial basis of land plus \$5,000 of not depreciable land improvements and \$23,000 of undepreciated building improvements. The original \$50,000 allocated to buildings is fully depreciated (straight line).

The farm house (Don's residence) was appraised at \$40,000 in Don's mother's estate and that became Don's initial basis. He has added \$11,000 of capital improvements making the current basis \$51,000. Additional land was bought for \$30,000 and title drainage was installed. The unrecovered cost of the drainage project is \$3,000 giving Don a basis of \$33,000 on the additional

land. The new barn cost \$130,000 but \$93,000 has been recovered through depreciation leaving a basis of \$37,000.

Note that only \$126,000 of Don's basis comes from his tax depreciation schedule. The remaining \$149,000 of basis is found in Don's "Detail" record of real estate purchases, acquisitions, and capital improvements.

Opportunities: The opportunity to maximize basis and minimize taxable gain by keeping accurate and continuous records of capital expenses is illustrated in the preceding example.

Other tax management opportunities for Don Detail include:

- a. Allocate a greater proportion of the sale to the farm house since it is Don's residence and roll it over into a new home or use Don's lifetime exemption.
- b. Allocate more basis to land and the main farm and less to cattle, crops, and machinery to take advantage of the maximum 28 percent tax on capital gains.
- c. Spread the sale out over two or more tax years.
- d. Consider a sale contract for some or all of the real property.

Precautions:

- Price allocations should not be changed after the sales agreement has been accepted and signed by the buyer unless all parties are in agreement.
- There will be ordinary income from the recapture of depreciation on machinery, equipment, single purpose livestock structures, and certain conservation expenditures.
- Although there will be no recapture for federal investment credit on dispositions after 1990, the potential recapture of New York State investment credit continues to be an important consequence.
- Farm filing privileges may be lost when major sales of farm property occur (see Myth #13).

A Major Income Tax Exclusion

Myth #2: There is a major tax exclusion that applies to the sale of all farm land and buildings.

Truth: There is a \$125,000 exclusion on the sale of a taxpayer's principal residence that farmers and all other qualified taxpayers may use once in their lifetime. There are no other major tax exclusions on the sale of farm real estate although there are opportunities to save taxes through trades or tax free exchanges (see page 10).

- Rules:** Once in your lifetime you may exclude up to \$125,000 of any gain realized on the sale of your principal residence from your gross income if:
- You are age 55 or over on the date the residence is sold or your spouse is 55 or over and she or he is joint owner of the residence and neither of you have ever this this one time exclusion..
 - You file a joint return if married. Your exclusion is \$62,500 if you are married and file a separate return. Single taxpayers generally qualify for the \$125,000 exclusion.
 - You owned the home and it was your principal residence for at least three out of the last five years.
 - You make the election to take the exclusion on Form 2119 filed for the year of the sale or you may make it by filing an amended return within three years. You also may revoke the election within three years of the sale.
 - You may use the rollover or non-recognition-of-gain provision in addition to the \$125,000 exclusion.

Example: Frank and Fern Furrow plan to see their 250 acre crop farm including their personal residence for \$360,000 and move into a lifetime retirement center. Frank is 69 years old, files a joint return with Fran, and qualifies for the \$125,000 lifetime exemption on the personal residence. The tentative sale agreement has the Furrow land at \$250,000, farm buildings \$25,000, and farm house \$85,000. The basis of their house is \$10,000. Frank and Fran may claim the \$75,000 exclusion on the gain from the sale of their home. The farmland and buildings have a basis of \$80,000 so there will be a taxable gain of \$195,000.

Opportunity: The Furrows can reduce the taxable gain on the sale of their farm by \$50,000 if they allocate \$135,000 to their residence and \$200,000 to the land. This is a potential federal and New York State income tax savings of approximately \$18,000 for the Furrows.

How Debt Affects Taxable Gain

Myth #3: When mortgaged or secured farm property is sold and the proceeds are used to pay off debt, taxable gain is calculated net of principal paid off.

Truth: Taxable gain is not reduced by mortgage and most other debt payments. Taxable gain is the difference between the sale price (less sale expenses) and the basis of property sold.

Example: Henry and Hilda Hardluck sell livestock, machinery, and farm real estate on a depressed market for \$620,000. Prior to the sale of the Hardluck farm property was valued at \$750,000 with debt of \$500,000 and a basis of \$200,000. The personal residence is not included in the sale. Sale expenses are \$20,000. The gain on the sale is $(\$620,000 - \$20,000 - \$200,000) = \$400,000$. The net sale proceeds after debt payments are only $(\$620,000 - \$20,000 - \$500,000) =$

\$100,000. The tentative federal and New York State income tax calculated at 35 percent is \$140,000, \$40,000 greater than the net proceeds from the sale.

Opportunities: The Hardluck farm business debt/asset ratio was very high (0.81) before the sale. This is an indication that the farm may not have been profitable in recent years. Look for net operating losses and unused New York State investment tax credit that can be carried forward to reduce the \$140,000 tax liability. If the tax liability is greater than available funds, work out a payment schedule with IRS before late penalties and interest are assessed.

Precaution: Initially, discharge of debt is treated the same as money received in calculating taxable gain. If the Hardlucks sold for \$520,000 and the Hardland bank canceled \$100,000 of their mortgage, their tentative taxable gain would have been the same. ($\$520,000 - \$20,000 - \$200,000 + \$100,000 = \$400,000$)

However, if the Hardlucks were insolvent before the discharge of debt and they could exclude discharge of indebtedness income that does not exceed the amount of their insolvency. If they had been solvent before or immediately after discharge, they may qualify for additional relief under the solvent farmer rules.

Myth #4: If I transfer property to my lender to satisfy my debt obligation, I will not have taxable income because I will receive no money.

Truth: Property that is transferred to a lender to discharge a debt is a taxable transfer, even though the debtor receives no cash.

Example: I.M. Blue has a grape harvester with a tax basis of \$15,000. The machine has a fair market value of \$35,000 and is subject to a secured lien of \$35,000. Blue transfers the machine to his creditor for a complete discharge of the \$35,000 debt owed.

Blue is treated as having sold the harvester to the creditor for its F.M.V. or \$35,000. His taxable gain is \$35,000 less \$15,000 basis or \$20,000.

Precaution: If the debt discharge is greater than the F.M.V. of property transferred the taxpayer may have taxable income from the discharge of indebtedness.

Example: I.M. Blue, II owes \$45,000 on his harvester that has a fair market value of \$35,000 and tax basis of \$15,000. He transfers the harvester to his creditor and the \$45,000 debt is discharged. Blue II has \$20,000 taxable gain from the transfer and \$10,000 of discharge-of-indebtedness income which may be taxable.

Exception: Discharge-of-indebtedness income is excluded from gross income if the discharge is in a bankruptcy case, or the discharge occurs when the taxpayer is insolvent, or the discharge is of qualified real property business indebtedness, or of qualified farm indebtedness of a qualified farmer.

Reporting Sales Proceeds

Myth #5: I can reduce or postpone the taxes on the sale of my farm by placing the proceeds in trust, escrow or non-taxable investments.

Truth: Once the farm is sold and the proceeds are constructively received (the money is credit to your account or available to you without restriction), you have received the sale proceeds for income tax purposes.

Example: Red and Rita Retiree sell \$200,000 of farm real estate to son Randy. The property has a tax basis of \$80,000. Randy pays \$50,000 down and borrows \$150,000 from Hometown Bank. Red and Rita direct the bank to put the \$150,000 into an escrow account that they plan to use to purchase an annuity for their retirement. Red and Rita have a taxable gain of \$120,000, (\$200,000 - \$80,000), to report in the year of sale. the \$150,000 put in escrow was available or constructively received when the real estate was sold.

- Opportunities:**
1. Red and Rita may have elected to finance the sale for Randy by holding his personal note or mortgage for \$150,000. The sale would qualify under the installment method of reporting and each principal payment would be reported in the year it was received.
 2. Red and Rita may have been able to invest the \$200,000 in like property that would qualify as a tax free exchange (see Tax Free Trades on page 10.)

Myth #6: When I sell my farm, the buyer and I must agree on the price of each asset and I must use these values to calculate my taxable gain.

Truth: Seldom does a contract of sale break down the total price to all the items included in a farm sale. Buyer and seller usually have some flexibility in how they allocate the basis when they transfer groups of farm assets.

- Rules:**
- IRS expects a reasonable allocation and if buyer and seller use widely different allocations IRS probably won't accept both.
 - If the contract of sale spells out an allocation, the IRS is likely to consider the terms as binding on both buyer and seller.

Myth #7: If I want to use the installment method of reporting income from the sale of property, I must elect to use this method by filing Form 6252.

Truth: You must report an installment sale using the installment method unless you elect not to use that method.

Rules:

- To elect out or to not use the installment method, report the full amount of gain from the sale on Schedule D and/or Form 4797, whichever is appropriate. Do not file form 6252.
- The election must be made by the due date including extensions, for filing the tax return for the year the sale takes place.
- Once made, the election generally cannot be changed.

Family Sales Agreements

Myth #8: If I sell the farm to my son/daughter we can determine our own sale price and repayment plan.

Truth: You can establish your own sale price providing it represents reasonable current market or agricultural use valuation. If your sale price is substantially below market value, IRS may consider the difference a gift made by the seller. You can establish your own payment schedule but the interest rate must meet IRS regulations.

Rules:

1. The sale of land between family members must have a stated interest rate of at least six percent or IRS will impute a seven percent rate. This rule applies to the first \$500,000 of land sold between related people in one calendar year.
2. All other investment sales where seller financing does not exceed \$3.3 million must have a minimum interest rate of nine percent or 100 percent of the Applicable Federal Rate.

Example: Assume Red and Rita elect to finance \$150,000 of the \$200,000 farm real estate sale to Randy. The \$200,000 sale price includes \$50,000 for buildings and \$150,000 for land. The \$50,000 down payment is specified for buildings, so the \$150,000 installment contract is for land and qualifies for six percent interest. They decide on a 10 year repayment period so the payments will be \$1,665 per month.

Opportunity: Applicable Federal Rates (AFR) for short and mid-term loans are currently running below eight percent interest. Check the current and prior month's AFR before completing the terms of an installment contract.

Myth #9: If I cancel one or more of my sons monthly installment payments, I can treat the cancellation as a gift and I will have no income tax to pay.

Truth: A canceled installment payment is not a gift for tax purposes.

Rule: If an installment obligation is cancelled, gain is recognized to the extent of the difference between the basis of the obligation and its fair market value at the time of cancellation.

Example: Red and Rita decide to cancel four months of Randy's installment payments because he needs the money to buy machinery. Of the \$6,660 canceled, \$400 is interest and \$6,260 is principal. Red and Rita must report the taxable gain from the \$6,260 of canceled principal. The \$400 of interest is a nonentry. Since it is not reported as an expense by Randy it is not reported as income by Red and Rita. Some of the \$6,260 of canceled principal should be classified as interest to satisfy the IRS imputed interest rules.

Tax Implications and Opportunities of Gifting Property

Myth #10: If I make gifts of farm property to my children, I am merely substituting one tax problem for another.

Truth: You can make substantial gifts without incurring any gift tax liability during your lifetime or for your estate. The value of a gift is not taxable income to the one who receives it.

- Rules:**
1. Every individual has an annual gift tax exemption of \$10,000 per donee. Together you and your spouse have an annual gift exemption of \$20,000 per donee.
 2. Every individual has a unified federal gift and estate tax credit of \$192,800 that is equivalent to a \$600,000 exemption. You can use the unified credit during your lifetime or to settle your estate.
 3. The unified credit is in addition to the annual gift tax exemption.
 4. When property is gifted, the donor's tax basis of the property is transferred to the donee.

Example: Gene and Gerry Generous decide to use a combination of sale and gifts to transfer the ownership of their fruit business to daughter and son-in-law, Fay and Frank Fortunate. They sell the original orchard and the packing and storage buildings for \$600,000. They gift fruit block H valued at \$50,000 to Fay and Frank. They rent to Fay and Frank six additional blocks valued at \$50,000 each with plans to sell or gift them in the future.

Together Gene and Gerry may give Fay and Frank \$40,000 each year under their annual \$10,000 exemption. Since they made a generous \$50,000 gift in one year and exceeded their annual exemption by \$10,000, they must file a gift tax return which IRS will keep to show that Gene and Gerry have used up \$10,000 of their lifetime exemption. If they continue to transfer the ownership of fruit blocks through annual gifts of \$50,000 or more they must continue to file annual gift tax returns. The amounts exceeding the annual gift exclusion will be accumulated to offset the \$600,000 unified gift and estate tax exemption.

- Opportunities:**
1. To minimize income taxes from their \$600,000 sale, Gene and Gerry should include property with the highest basis. They have included the new apple storage building that has a basis of \$200,000. They value it at \$200,000 and avoid all taxable gain on the sale of the storage building.
 2. To help Fay and Frank minimize income taxes on future income and property sales, Gene and Gerry should gift property with a high basis. Fruit block H has been in production for only one year and has a basis of \$25,000. The fruit trees have a basis of \$20,000 and may be depreciated by Fay and Frank.

Precaution: New York State recognizes the \$10,000 annual gift exemption but not the \$600,000 lifetime exemption. The New York State estate and gift tax is imposed on cumulative transfers of \$108,334 or more.

Transferring Assets to Form a Partnership

Myth #11: To help my junior partner gain a larger share of equity and financial responsibility, I can transfer my farm business assets and debt to a partnership without tax implications.

Truth: Usually no gain or loss is recognized when assets are contributed to a partnership in exchange for a partnership interest. Transferring debt to a partnership will reduce the assets that a junior partner must contribute to gain the desired level of equity but it can result in a serious tax trap.

Rule: A contribution of liabilities which exceed the adjusted basis of assets contributed to the partnership plus the liabilities assumed by the contributing partner, is treated as a taxable transaction.

Example: Senior Farmer contributes \$190,000 of raised cattle and feed, and \$10,000 of cash to help establish a 50/50 partnership with Junior Farmer. The partnership plans to lease the machinery and real estate from Senior Farmer. Senior Farmer also contributes \$80,000 of debt. The basis of Senior Farmer's assets contributed is only \$10,000 because raised cattle and feed have a zero basis.

Adjusted basis of assets contributed by Senior Farmer	\$ 10,000
Senior Farmer's liabilities assumed by partnership	-80,000
Senior Farmer's 50% share of partnership liabilities	<u>40,000</u>
Tax basis of Senior Farmer's partnership interest	\$-30,000

Senior Farmer has a negative basis of \$30,000 which must be returned to \$0 by reporting a gain of \$30,000 for the year the partnership is formed.

Opportunity: Try to avoid this tax trap by having Senior contribute assets with more basis, contribute fewer liabilities or increase Senior's share of the partnership.

Tax Free Trades

Myth #12: Tax free trades are limited to machinery and equipment.

Truth: Any property, including real estate held for business use or investment, may be exchanged for like property resulting in no taxable gain if arranged and managed correctly.

Rules:

1. Real property exchanged (given up and received) must be business or investment property.
2. Property held for sale does not qualify.
3. The property exchanged must be "like" property. This means farm machinery and equipment for farm machinery and equipment, and business real estate for business or investment real estate. For example, farm real estate may be exchanged for business real estate in town or for undeveloped real estate in another state.
4. The property to be received must be identified within 45 days after the transfer of property given up and the entire transfer must be completed in 180 days or by the due date for the return of the year the property was given up.
5. Money from the first part for the transfer may be escrowed to secure the completion of the transfer without it being treated as a constructive receipt. Make sure this escrow account is properly handled. Seek advice from competent tax advisors.
6. If a third party arranges and manages the transfer it must be a qualified, independent tax free exchange facilitator, and cannot be the property owner's accountant, attorney, or real estate broker.

Example: A.B. Alternative decides to discontinue crop farming to become the owner-manager of an apartment building in town. His crop farm real estate is valued at \$360,000 excluding his personal residence and has a tax basis of \$100,000. The apartment building is available for \$320,000. A.B.'s attorney obtains the

services of a firm qualified in arranging tax free exchanges. They find a buyer for A.B.'s farm and put \$320,000 from the transfer in escrow on February 1st to be used to acquire the apartment building. A.B. cannot receive the money that is in escrow unless the apartment building or a suitable substitute cannot be acquired in 180 days. The exchange is completed in 90 days and the \$320,000 escrow is used to acquire the apartment building and pay the associated fees.

A.B. Alternative has a \$320,000 tax free exchange plus \$40,000 gain from the sale of his farm.

The Estimated Tax Trap

Myth #13: As long as I do not receive much off-farm income, I can continue to use farm taxpayer filing rules and avoid quarterly estimates.

Truth: You can continue to file your return on March 1st and avoid quarterly estimates if at least two-thirds of your total gross income was from farming during this or for the last taxable year.

Rules:

1. Total gross income includes your spouse's income if you file a joint return, interest income, taxable gains from the sale of all business and investment property as well as gross income from farming.
2. Gross income from farming includes total farm income (receipts) from Part I Schedule F, farm rental income from Form 4835, gross farm income from Schedule E, and gains from the sale of livestock held for breeding, dairy, draft or sporting purposes from Form 4797.

Example: Albert D. Dairyfarmer sold his dairy cattle last year and has sold much of his farm machinery this year. He plans to sell some farm real estate next year. Mr. and Mrs. Albert D. Dairyfarmer file joint returns. Last year they had a total gross income of \$190,000 which included: \$30,000 Mrs. A.D.'s salary, \$5,000 interest and dividend income, \$60,000 total farm income from Schedule F, and \$95,000 from the sale of dairy cattle. Gross income from farming was \$155,000 (\$60,000 + \$95,000) or 82 percent of total gross income. Mr. and Mrs. A.D. qualified to use the farm taxpayer filing rules last year and that qualification covers them for this year.

This year their estimated total gross income is \$130,000; \$32,000 Mrs. A.D.'s salary, \$8,000 interest and dividends, \$10,000 from Schedule F, and \$80,000 gain from machinery sales. Total gross income from farming is only \$10,000, less than 10 percent of total gross income. The A.D.'s no longer qualify as farm taxpayers. Next year they must follow the estimated payment and quarterly filing rules required of non-farm taxpayers.

Plan Ahead Recognizing Deferred Taxes

Myth #14: Deferred taxes are the income taxes that I may have to pay when I sell my farm and they do not affect my current financial position.

Truth: Deferred taxes are an estimate of the income taxes that would be incurred if the farm were sold at current fair market values at the end of this year. Deferred taxes are a liability that occurs when farm equity is converted to retirement equity and must be included on the balance sheet used for retirement planning. They do affect the net worth or equity available for living after farming.

Example: Ned and Nancy Nestegg have total farm assets of \$730,000, nonfarm assets totaling \$65,000 and total farm mortgages and loans of \$225,000. They plan to sell the farm within a year and to invest over \$500,00 for retirement income. They have neglected to calculate the deferred taxes that must be paid on gain from the sale. If they had used the services of a competent tax accountant or financial planner, they would have included a deferred tax liability of approximately \$175,000 reducing the Nestegg's nestegg to \$325,000.

Opportunity: Tax management strategies should be considered to reduce the income tax on the sale of farm assets. Strategies include spreading the sale of assets over two or more years, renting assets that will not lose value, allocating the maximum allowed to the personal residence, finding a tax free exchange involving sound investment property or using a qualified charitable remainder trust for real property.

OTHER A.R.M.E. EXTENSION BULLETINS

- | | | |
|-----------|--|--|
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Stuart F. Smith
Karen Livingston
James A. Hilson
A. Edward Staehr
Thomas Weeks
Jacqueline M. Hilts
Charles Z. Radick
Linda D. Putnam |
| No. 96-12 | Dairy Farm Business Summary
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Paul Cerosaletti
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