

## Knowledge Exchange Report

### The Federal Estate Tax Effect on the Farming Community

Everyone will die at some point. Whether their estate is subject to the Federal Estate Tax is dependent upon the size of their estate and to whom the assets will be distributed. This estate typically includes a combination of real estate, cash, retirement funds and some personal assets.

For a typical individual possibly subject to federal estate tax, his/her real estate will consist of a primary residence and perhaps a vacation home. The balance of their estate is likely to be more “liquid” assets, such as stocks, bonds and retirement funds.

Farm owners typically have the opposite asset balance. They have invested all of their earnings into increasing and improving farm real estate, often even including “investing” their retirement funds into it. By doing so they are typically “real estate rich and cash poor.” This imbalance provides them with a strong real estate asset to generate business profits but a weak cash position to pay estate taxes. If a farm owner is the final operator of the farm business then the assets can be sold to pay the estate tax liability. If the “next generation” desires to continue, this is where the financial challenge occurs.

#### Brief History and Current Tax Law

In 2009, the federal estate tax law allowed the first \$3.5 million (less any gifts given in excess of the annual exclusion up to \$1 million) in net worth to be exempt from federal estate taxation. The 2009 federal estate tax rate was 45%. Thus, a \$4 million estate had the first \$3.5 million exempted and the remaining \$500,000 taxed at 45%, or a \$225,000 federal estate tax liability.

In 2010 there was no federal estate tax.

In 2011 the federal estate tax law allowed the first \$5 million (less any gifts given in excess of the annual exclusion up to \$5 million) in net worth to be exempt from federal estate taxation. The federal estate tax rate was 35%. Thus, a \$6 million estate had the first \$5 million exempted and the remaining \$1,000,000 taxed at 35%, or a \$350,000 federal estate tax liability.

In 2012 the federal threshold was increased by inflation to \$5,120,000, but all other 2011 rules applied.

In 2013 the estate tax exemption returns to the 2001 exemption level of \$1 million, unless the law is changed. The tax rate will increase to 55% and there will not be marital portability (see the marital deduction/portability definition below).

***Note:** The discussion above does not include the marital deduction, nor does it include the special use valuation allowed in Section 2032 of IRS law, originally approved in 1986. It also does not include the use of gifting to reduce estate taxes. These three items will be discussed in greater detail below.*

## Estate Tax Proposals

Under consideration in Congress are a number of proposals that would revise the current estate tax law. These range from permanent elimination of the estate tax to various exemption levels and special valuation provisions. A continuation of the portable marital deduction has also been discussed (it is in effect in 2011 and 2012) as well as consideration for adoption of an estate tax exemption level and then adjusting it for inflation in future years. Exempting farmland from estate tax was proposed in committee but was subsequently rejected from consideration.

For purposes of this analysis we have considered the three versions of the following:

### *Estate Tax Exemption Level and Tax Rate for 2013 onward*

- Existing Law - Revert back to \$1 million exemption and 55% tax rate.
- Return to 2009 rules of a \$3.5 million exemption with a 45% tax rate.
- Continuation of the 2011 \$5 million exemption with a 35% tax rate.

## Explanation and Definitions

*Gross Federal Estate* – This is the total of all assets owned by an individual less any liabilities owed. This value is the starting point for determining the estate tax that may be due.

*Federal Estate Tax* – The estate tax is a tax on your right to transfer property at the time of your death. The estate tax may apply to your taxable estate, which is your gross estate (everything you own or have interests in at the date of death), less allowable deductions, including the federal exemption.

*Federal exemption level* – The federal exemption level is the value of a person's estate that is not subject to federal estate tax. This is the dollar value of assets that can be transferred to someone, other than a spouse or a qualified charitable organization without taxation. In 2012 this amount was \$5.12 million.

*Impact of Gifting* – During a person's lifetime they may gift annually, in any form, to as many people as they want up to the annual exclusion (\$13,000 in 2012 and \$14,000 in 2013 and onward). In addition, each person has a lifetime gifting exclusion of \$5.12 million. Gifting is sometimes done to transfer rapidly appreciating assets to the next generation to minimize estate taxes. As a consequence, any lifetime gifting used (over the annual exclusion) reduces the federal estate tax exemption level. For example, if an individual used \$600,000 of his or her lifetime gift exclusion their federal exemption level for estate tax purposes was reduced in 2012 from \$5.12 million to \$4.52 million.

*Marital deduction (including portability)* – A person can transfer all or a portion of their estate to their spouse with no estate or gift tax consequences. This amount is reduced from their gross taxable estate. While this may limit the federal estate tax at the death of the first spouse, at the death of the second spouse the assets of both are now included in the gross federal estate of this second spouse. Because the first spouse could have transferred their federal exemption level (\$5.12 million in 2012) to the next generation without federal tax this exemption amount is "wasted." *Note: This often happens with "sweetheart" wills that state that all assets go to the surviving spouse. They are great for simplicity and fine for combined estates well below the threshold level, but not for more sizeable estates.*

*Portability* – The ability of the second spouse (to die) to use the first's spouse's federal exemption amount in their estate. This has the effect of doubling the exemption for a married couple (to \$10.24 million in 2012),

even with a sweetheart will. Portability was put in effect for 2011 and 2012, but will not be available in 2013 under current law.

*Special use valuation* – A farm business is allowed to reduce their gross federal estate by a “special use valuation” if the farm is transferred to a direct lineal descendant and continues to be farmed for the next ten years. This special use valuation is the value of farmland if it’s only use is as farmland, and could not be developed into house lots or other uses that would result in a greater value than farmland (The highest and best use theory of appraisal). This special use valuation is indexed for inflation. The maximum reduction in 2012 was \$1.04 million. Thus, if a farmer’s gross estate is \$6.124 million or less and the difference between the “fair market value” of their farmland and the “farmland value” is more than \$1.04 million, there would be no federal estate tax as long as their lineal descendent continued to farm for at least ten years. If the farm ceased operation prior to that time or is sold the federal estate tax that would have been due without this special use valuation is now recaptured.

*Tax Basis Step-up* – The “tax basis,” (The purchase price, plus acquisition costs, minus deductions, such as depreciation taken), used to determine capital gains/losses for tax purposes, of an asset is stepped through the estate process from its tax basis cost to current fair market value at the time of the person’s death. For example, a parcel of land is purchased for \$50,000. At the date of the death of the landowner, the land is now worth \$300,000. If the individual sold the property just prior to their death there would be a \$250,000 gain (\$300,000 sale price - \$50,000 tax basis). Through the estate process the tax basis is stepped up to \$300,000. If the land is then sold after the date of death there is no gain on this sale. Further, if an heir chooses to sell the land in the future, the tax basis used would be the stepped-up \$300,000 versus the \$50,000 original cost.

## Examples

In order to better illustrate the challenges faced by farming families desiring to continue their farming operation see examples of two family farming operations below. The first one has a net worth of \$5 million and the second one of \$12 million. \$5 million in net worth is not that unusual for a farm business, especially when the farm is located in high real estate value areas, typically near metropolitan centers. \$12 million in net worth may be a somewhat larger farm operation, but not uncommon. In most cases the significant net worth is due to real estate appreciation accumulated through farm ownership by multiple generations, not necessarily through strong earnings.

*Farmer Smith* – Sam Smith owns a 250-acre crop farm on the outskirts of a major city. He operates the farm with his two sons. Sam has two other children not involved on the farm. His wife died two years ago and the “sweetheart will” left all the assets to him. His farm real estate is worth \$4.5 million. His farm equipment is worth \$500,000. He has \$100,000 in cash and stocks and \$200,000 in retirement funds but Sam still has a \$300,000 mortgage on the farm. Total net worth is \$5 million. Net annual income has been \$100,000; enough to draw \$60,000 for personal living expenses and \$40,000 for debt payments, capital purchases or for retirement.

*Farmer Jones* – Jerry Jones and his wife June own a 1,500 cow dairy farm supported by 2,500 acres of farmland. They have four daughters, all of whom are involved in the business. Jerry has invested heavily (nearly \$3 million on the barn and milking parlor and \$1.5 million for additional cropland) in the farm over the last ten years, in anticipation of making the farm large enough and efficient enough for all four daughters to make a living and for June and himself to retire on. The house, dairy facility, and farmland are worth \$10 million. The dairy herd is worth \$2 million and equipment is worth \$1 million. They also have \$500,000 in stocks and bonds and \$500,000 in retirement funds. Offsetting these assets is a \$2 million long term mortgage on the farm. Total net worth is \$12 million. Earnings in 2010 were excellent, allowing Jerry to

build up cash reserves and pay down debt. 2011 was an OK year and 2012 has been terrible, forcing him to rapidly deplete his cash reserves. The four daughters are paid \$40,000 each plus medical benefits. They each have a small home on the farm.

### Federal Estate Tax Implication of the Three Options

To illustrate the impact of the various federal estate tax scenarios we have analyzed the impact on the two farm examples detailed above.

#### Example #1 – Farmer Smith

Law Scenario	Description	Tax Liability
Current Law in 2013	\$1 million exemption and no special use exemption	\$2,200,000 due
Current Law in 2013	\$1 million exemption and \$1million special use exemption	\$1,650,000 due
Return to \$3.5MM	\$3.5 million exemption with no special use exemption @ 45% tax rate	\$675,000 due
Return to \$3.5MM	\$3.5 million exemption and \$1 million special use exemption @ 45% tax rate	\$225,000 due
Return to \$3.5MM	\$3.5 million exemption with portable marital deduction @ 45% tax rate	No tax due
Remain at \$5.0MM	\$5.0 million exemption with no special use exemption @ 45% tax rate	No tax due
Remain at \$5.0MM	\$5.0 million exemption with \$1.0+ million special use exemption @ 35% tax rate	No tax due
Remain at \$5.0MM	\$5.0 million exemption with portable marital deduction @ 35% tax rate.	No tax due

## Example #2 – Farmer Jones

Law Scenario	Description	Tax Liability
Current Law in 2013	\$1 million exemption, with no special use exemption and no marital exemption	\$6,050,000 due
Current Law in 2013	\$1 million exemption, with no special use exemption and \$1 million marital exemption	\$5,500,000 due
Current Law in 2013	\$1 million exemption, \$1 million special use exemption and \$1 million marital deduction	\$4,950,000 due
Return to \$3.5MM	\$3.5 million exemption with no special use exemption and no use of marital exclusion @ 45% tax rate	\$3,825,000 due
Return to \$3.5MM	\$3.5 million exemption with no special use exemption and use of \$3.5 million marital exclusion @ 45% tax rate	\$2,225,000 due
Return to \$3.5MM	\$3.5 million exemption, \$3.5 million marital exemption and \$1 million special use exemption @ 45% tax rate	\$1,800,000 due
Return to \$3.5MM Higher Special Use	\$3.5 million exemption, \$3.5 million marital exemption and \$3.5 million special use exemption @ 45% tax rate	\$675,000 due
Remain at \$5.0MM	\$5.0 million exemption with no special use exemption and no use of marital exclusion @ 35% tax rate	\$2,450,000 due
Remain at \$5.0MM	\$5.0 million exemption with no special use exemption and use of \$5.0 million marital exclusion @ 35% tax rate	\$700,000 due
Remain at \$5.0MM	\$5.0 million exemption, \$5.0 million marital exemption and \$1 million special use exemption @ 35% tax rate	\$350,000 due
Remain at \$5.0MM Higher Special Use	\$5.0 million exemption, \$5.0 million marital exemption and \$3.5 million special use exemption @ 35% tax rate	No tax due

## Summary

If nothing is done and the federal exemption reverts to \$1 million in 2013 the federal estate tax would put most farmers with over a \$2 million federal estate out of business since they would be forced to sell their farm assets to meet the estate tax liability.

If the federal estate tax is returned to the 2009 level (\$3.5 million threshold) it will still be a burden for a midsized farm (like Farmer Smith), unless the special use exemption, or marital deduction is used. This \$3.5 million threshold for the federal estate tax for a large farm (like Farmer Jones) would likely force them to sell the farm to pay the estate tax.

Retaining the 2011 exemption amount (at the \$5.0 million threshold) and/or adding a portable marital deduction and/or increasing the special use exemption works well for Farmer Smith and results in a tax that can likely be paid by Farmer Jones.

## Final Comments

Federal estate tax owed would need to be paid either from the liquidation of assets and/or from borrowed funds. In most farm situations, this use of cash for a “non-productive” purpose would reduce or eliminate the farms financial capacity to continue operations. Obviously the higher the exemption level, the fewer the number of farms to be impacted.

The use of a portable marital deduction and an unlimited special use exemption, but with a recapture provision upon discontinuing the farm operation would also be a significant benefit to keep farms in production. This combination allows family farm operations to be transferred and operated by next generation, with operating earnings used to reinvest and expand the operation. This is also good for agriculture and for the local economy. When (and if) the farmland is sold, a future generation will then have the sale proceeds to pay the recapture tax, providing the federal government with a revenue source.

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