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Farm & Ranch Estate Planning

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2002 FARM CONSERVATION TAX UPDATE

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In September 1999, American Farmland Trust published a revised estate planning guide for farmers, ranchers and their families to help them plan for the future of their farms and ranches. The recent changes in the tax laws highlight the need for sound estate planning that is tailored to fit the needs of individual circumstances and uncertainty about future tax legislation. Of course, the need for useful information about the basic strategies and conservation options remains essential. Estate planning continues to be vitally important for farm and ranch families, their businesses and their land.

The *Economic Growth and Tax Relief Reconciliation Act of 2001*, signed into law by President Bush on June 7, 2001, will significantly affect farmland conservation and farm estate planning and transfer because the provisions include:

- Reduced estate and gift tax rates
- Reduced marginal income tax rates
- Increased exemptions for estate and gift taxes
- Elimination of geographic limitations for 2031(c)
- Estate tax repeal for 2010
- Modified carryover basis to accompany estate tax repeal

While the legislation repeals the estate tax for 2010, a sunset provision in the law means that the estate tax is effectively repealed *only* for 2010. As before, estate planning remains key.

Despite the considerable uncertainty about what Congress will do between now and 2010, there are significant changes that start to phase in immediately. In this update, we will briefly outline the major changes.

Reduced Estate Tax Rates

Starting in 2002, the Act reduces top estate tax rates from 55% to 50%, with further gradual reductions to 49% in 2003, 48% in 2004, 47% in 2005, 46% in 2006 and 45% in 2007-2009. The generation-skipping tax rate will also track the estate tax rate reductions.

Increased Exemptions

Also effective in 2002, the unified credit exemption amount is increased to \$1 million from \$675,000 for estate and gift taxes and will gradually increase to \$3.5 million in 2009 for estate taxes. In 2002-2003 it will be \$1 million; in 2004-5 it will be \$1.5 million; in 2006-8 it will be \$2 million; and in 2009 it will be \$3.5 million. The gift tax exemption will remain at \$1 million. As a result, for the next several years (2003-2009), there will no longer be a “unified” exemption system that applies to both estate and gift taxes.

Income Tax Reductions and the AMT

In addition, marginal income tax rates will be reduced gradually over the next five years: the 28% rate will drop to 25% by 2006; the 31% rate will fall to 28% in 2006; the 36% rate will go to 33% and the highest rate of 39.6% will be reduced to 35%. Because regular income tax rates have been reduced without corresponding reductions in the alternative minimum tax (AMT), the AMT may become more of a factor in future years.

Reduced Estate Tax Impacts

The recent changes will significantly reduce estate tax impacts until 2010. In addition, the new legislation removed geographic restrictions for donated conservation easements eligible for estate tax benefits under Section 2031(c) of the tax code. The limited exclusion of land subject to a qualified conservation easement will be \$500,000 for 2002 and subsequent years. However, this incentive may have limited applicability as exemption levels increase over the next several years and if the estate tax repeal is extended beyond 2010.

Reduction of Credit for State Death Taxes

State death tax credits will be reduced to 75% of existing levels in 2002, 50% in 2003 and 25% in 2004. A deduction for state death taxes will replace the credit in 2005. The repeal of the state death tax credit will shift much of the revenue costs of the estate tax changes to the states and could lead to increased inheritance taxes in states that rely on such taxes for revenue.

Family-Owned Business Deduction

The FOBD is repealed for 2004. Recapture rules continue to apply until either the recapture period expires or recapture tax is triggered.

Elimination of Geographic Limitations for 2031(c)

The limited estate tax exclusion for qualified conservation easements of \$500,000 will no longer be subject to geographic limitations. However, this incentive to donate conservation easements on farm and ranch land may have limited applicability as exemption levels increase over the next several years and if the estate tax repeal is extended beyond 2010.

Repeal for 2010

Two major changes will accompany the estate tax repeal for 2010 – a system of modified carryover basis to tax capital gains on inherited property and a reduction of the highest gift tax rate to 35%. There is no change in the basis rules until the estate tax is repealed in 2010, but at that point property transferred at death will be treated the same as a lifetime gift in determining the basis in the property – it will receive the adjusted basis of the decedent/donor. In 2010, an estate may increase the basis of up to \$1.3 million in assets. In addition, \$3 million in assets transferred directly to a surviving spouse or to a qualified trust will also receive a “stepped-up” basis at death. These structural changes are intended to maintain a transfer tax system that captures revenue from transfers of appreciated assets – one way or another. Carryover basis will create record keeping challenges and may prove unpopular with taxpayers.

Uncertainty after 2010

No one is really sure what will happen to estate and transfer taxes after 2010 because of the sunset provision in the law. As Professor Roger A. McEowen at Kansas State University wrote in a recent issue of the *Agricultural Law Update*, “Certainly what has been accomplished has been the injection of tremendous uncertainty in estate planning for perhaps the next 10 years.”

Regardless, estate planning remains a critical farmland conservation issue, because estate taxes (reduced or repealed) are only part of farm and ranch transfer equations. The issues of developing management capacity, transferring management and ownership of the agricultural operation, treating children fairly and ensuring financial security all remain critical components of comprehensive transfer and estate plans. As a result, good estate planning will continue to be essential for farmers and ranchers who want to keep their land in agriculture and pass it on to the next generation.



DESCRIPTION

Estate planning should lay a framework for a smooth transition of farm or ranch ownership and management. It can provide for the needs of all family members, even those who leave the operation. It can help reduce high inheritance taxes on land made more valuable by inflation and non-farm development pressure. And proper estate planning can address the settlement problems that arise because land is not a liquid asset.

An estate plan is more than a will. A will is an important part of the plan because it names heirs, nominates an executor and appoints guardians for dependents. But a will alone cannot guarantee a secure future for the farm family, land or business.

A good estate plan should accomplish at least four goals:

- Transfer ownership and management of the agricultural operation, land and other assets;
- Avoid unnecessary transfer taxes (income, gift and estate);
- Ensure financial security and peace of mind for all generations;
- Develop the next generation's management capacity.

Laws, especially tax laws, change. Two important elements of estate planning are to set goals and then to revisit them over time as families, finances, priorities and laws change. As part of this goal-setting process, landowners must take inventory of their assets and be sure they fully understand who owns what and how titles to the property are held.

BASIC TECHNIQUES

Farmers and ranchers should complete a will and keep it updated. A living will, health care

proxy and the designation of power of attorney are important ways to ensure that the family will be able to make decisions if the landowner becomes seriously injured or terminally ill. The estate planning process is a good opportunity to resolve business operation and management issues and to transfer assets. For tax and other reasons, it makes sense to start transferring operating assets as soon as both generations are comfortable with the commitment.

The estate planning and farm transfer process is also a good time for landowners to evaluate their present business arrangements and decide whether those arrangements meet their current needs and help achieve their goals. They should choose the most appropriate form of business organization, whether it is a sole proprietorship, partnership or corporation. Written agreements are essential.

TRANSFER AND TAX REDUCTION STRATEGIES

- Agricultural conservation easements can permanently protect farmland from non-farm development and significantly reduce transfer taxes in cases where the market value of the land is much greater than its restricted value;
- Annual gifts of assets can help transfer the business and reduce transfer taxes;
- Buy/Sell agreements can ensure an orderly transfer of the farm business;
- Life insurance can be used to fund buy/sell agreements, establish trusts, provide for non-farming heirs or pay estate taxes;
- Limited partnerships or corporations can allow separation of management and ownership of the business, if desired;
- Long-term care insurance can protect family assets from being used to pay for nursing home costs;

FACT SHEET

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AND ESTATE

PLANNING

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FARM TRANSFER AND ESTATE PLANNING

For additional information on farmland protection, the Farmland Information Center offers publications, an on-line library and technical assistance.

To order AFT publications, call (800) 370-4879. The farmland information library is a searchable database of literature, abstracts, statutes, maps, legislative updates and other useful resources.

It can be reached at <http://www.farmlandinfo.org>. For additional assistance on specific topics, call the technical assistance service at (413) 586-4593.

- Minority discounts can substantially reduce transfer tax liability when minority interests of family farm businesses are transferred;
- Purchase of agricultural conservation easements (also known as purchase of development rights) programs can protect farmland, reduce taxes and provide cash for retirement and estate planning needs;
- Transferring management responsibility and asset ownership gradually can provide a smooth transition for the agricultural operation from one generation to the next;
- Trusts can provide financial security for surviving spouses, children and grandchildren.

ISSUES AND OPTIONS

Liquid assets - cash and cash equivalents - are important to settling farm and ranch estates. Having cash allows farm families to pay expenses and medical bills without selling land or farm equipment. Liquid assets also may be used to divide an estate fairly among heirs.

It is important to remember that an equitable settlement does not necessarily mean creating equal shares of a farm or ranch estate, because the children who are involved in a family agricultural enterprise have generally contributed a substantial amount of their time, energy and resources to make the business succeed. These children may have substantial "sweat equity" in the operation they inherit.

Balancing commercial and conservation goals in farm estate planning also is challenging, because farms are businesses. However, with careful planning, farmers and ranchers can take advantage of conservation options that protect land without unduly restricting agricultural enterprises. These conservation options should be integrated into estate plans to ensure long-term protection of both land and farming operations.

Successful farm transfer and estate planning require a team effort - including family, financial, farm management, tax and legal expertise. Because plans must be tailored to individual circumstances, they must be designed to meet a variety of unique situations. Landowners must be sure to talk to their families and find the professional legal and financial assistance they need to accomplish their goals.

ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001

The Economic Growth and Tax Relief Reconciliation Act of 2001 contains several provisions that affect farmland conservation and farm estate planning and transfer including:

- A dramatic increase in the estate tax exclusion: \$1 million in 2002-3 up to \$3.5 million in 2009;
- Repeal of Estate Tax in 2010;
- A reduction of highest tax brackets;
- Modified carryover basis in 2010;
- Removal of geographic limitations for donated conservation easements eligible for estate tax benefits under Section 2031(c) of the tax code; and
- A sunset provision.

These recent tax law changes have provided significant estate tax reductions as well as some additional uncertainty for estate tax planning and farm transfer. Farm and ranch owners should contact their advisers to determine how those changes will affect their planning efforts.