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Fact Sheet

Fact Sheet 778

Estate Planning for Farm Families

All people who own real or personal property should engage in estate planning. While few of us like to think about our own eventual death, planning can ensure that we decide—rather than the state or a probate court—who receives our belongings. Estate planning is particularly essential for farmers whose real estate property values have increased dramatically because of urbanization. Families who find themselves land rich but cash poor and who fail to minimize their estate tax burdens may be forced to sell land in order to pay estate taxes or to buy out other heirs.

The Taxpayer Relief Act of 1997 contains provisions, which apply specifically to farm estate planning, that can be of great benefit to farm families. What follows is a discussion of some of the new or amended provisions of the act, along with steps you can take to reduce tax burdens and pass on your farm to heirs. Among the topics covered are the Special Use Valuation, the new Family-Owned Business Exclusion, lower interest rates for installment payments, and property trusts.

While this fact sheet presents some tools you can consider in your estate planning, each individual's and family's circumstances are different. Therefore, you should seek the advice of a tax attorney, accountant, or other financial advisor. The information included here should prepare you to have a fruitful session with these advisors.

Setting Goals

The first step of estate planning is setting goals for your income and your real and personal property, taking into consideration your needs and desires. Real property is your land, houses, and other structures, including all improvements you have made to any of these. Personal property includes cars, bank accounts, stocks and bonds, livestock, and farm equipment.

Examples of goals that you may want to consider in estate planning are:

- to expand the farm to enable your children to earn enough to support their families;
- to provide retirement income for yourself and your spouse;
- to provide a steady income for dependents such as minor children or elderly parents;
- to distribute your assets among your children and grandchildren;
- to ensure that your children or other heirs do not fight over the property; and
- to minimize estate taxes.

Determining what your goals are requires that you ask many questions of yourself, your spouse, and your children. For example, is there someone who wants to take over the farm? Does the family want the property to stay in farming, or is selling to the highest bidder acceptable? Who will manage the farm if you become ill or disabled? Knowing what goals you hope to accomplish enables you to decide which of the tools available for estate planning will help you most. Also, talking with your heirs and stating your wishes now can prevent disagreements and squabbles from occurring following your death as well as helping your heirs in their decision-making. For more general information on setting goals for farmers, see Fact Sheet 670, "Strategic Planning: Drafting a Blueprint for Your Farm Business." For more information on estate planning goals, see Fact Sheet 414, "Estate Planning—Goals, Net Worth, and Final Instructions."

Determining Your Net Worth

Figuring out your net worth requires that you sit down and list your assets and liabilities. You may be surprised how much your net worth actually is, once you have written it down, especially if your land or business has been increasing in value. Net worth is assets minus liabilities or debt. Assets are your land, buildings, livestock, equipment, personal residence, cars, other personal property, savings, stocks and bonds, and pensions or other retirement savings. Assets can also include the value of any life insurance policies. Liabilities are any outstanding debts you owe on your assets, such as mortgages, other loans, and policy premiums. For more information on calculating net worth, see Fact Sheet 540, "Assessing and Improving Farm Solvency."

If your net worth is more than $675,000 for an individual, you will want to make plans to minimize your estate taxes. Even if your estate falls below the exempted amount of $675,000, estate planning can facilitate the transfer of your property and ensure the continuation of the business.

Federal Estate Taxes and the Unified Credit

Federal estate tax rates range from 37 to 55 percent. As shown in Table 1, as the value of the estate increases, the marginal rate at which it is taxed increases. Thus, for amounts between $675,000 and $1 million, the marginal tax rate is 37 percent. Currently, estates valued at less than $675,000 owe no estate tax. Amounts more than $675,000 and less than $1 million are taxed at 37 percent. Once the estate value tops $3 million, additional value is taxed at 55 percent.

The $675,000, which is exempt from estate and gift tax, is called the "unified credit amount" because it applies to the value of your estate at death and the value of all your taxable lifetime gifts added together. The unified credit amount takes the form of a tax credit of $220,550 against the first $675,000 of value.

Under the Taxpayer Relief Act, Congress implemented a phased-in increase in the unified credit, which means that less of the sum of the value of your gifts to others and your estate's gross value is subject to taxation by the federal government. Since 1976, gifts of more than $10,000 a year to any particular donee are taxed. But because this $10,000 limit is now indexed for inflation to the lowest $1,000, it is likely the tax-free limit will rise in future years. (As it is, some gifts can now exceed $10,000 without facing the gift and estate tax—gifts to a spouse; donations to charity; tuition paid directly to a school or college; and medical expenses paid directly to a physician, nursing home, or hospital.)

Table 1. Federal Estate and Gift Tax Rates[1]

Estate	Marginal Tax Rate	Federal Estate Taxes Owed
$ 675,000 or less	18–37%[2]	0
$ 700,000	37%	$ 9,250
$ 750,000	37%	$ 27,250
$ 1,000,000	39%	$ 125,250
$ 1,250,000	41%	$ 227,750
$ 1,500,000	43%	$ 335,250
$ 2,000,000	45%	$ 560,250
$ 2,500,000	49%	$ 805,250
$ 3,000,000	53%	$1,070,250
More than $3,000,000		$1,079,500 + 55% of amounts more than $3,000,000

[1]The taxes owed apply to estates of individuals who died in 2000 and 2001. In future years the amount exempted and taxes owed will continue to decrease.

[2]The tax rate actually ranges from 18 percent on the first $10,000 of taxable gifts and estate to 55 percent on taxable gifts and estate over $3 million. Because of the unified credit, however, the first applicable tax rate is 37%, which in 2000 was imposed on estates larger than $675,000.

Table 2. Increases in Unified Credit under the Taxpayer Relief Act of 1997

Year	Unified Credit	Exempted Amount
1999	$211,300	$ 650,000
2000 through 2001	$220,550	$ 675,000
2002 through 2003	$229,800	$ 700,000
2004	$287,300	$ 850,000
2005	$326,300	$ 950,000
After 2005	$345,800	$1,000,000

Each individual has the right to use a unified credit to pay federal taxes on the value of gifts above the limit and on the value of the estate. In 2000, for example, individuals with estates valued at $675,000 or less can use the unified credit of $220,550 to cover all the taxes due. Assuming no lifetime taxable gifts were made, these individuals do not have to pay any money to the federal government or file an estate tax return. Only individuals whose gross estate exceeds the exempted amount must file the estate tax return. Table 2 shows the increases authorized in the Taxpayer Relief Act of 1997. As the unified credit increases, the tax rates in Table 1 will be adjusted.

Making a Will

Besides talking with your family about the disposal of your belongings, you also need to make a will, the legal document that specifies what you want to have done with your personal and real property. Your will needs to be signed and dated in front of two witnesses.

Dying Without a Will

If you die and do not have a will, the State of Maryland will allocate your property in the following manner: your spouse will receive one-half and any minor children of yours will share the remaining one-half. If all children are adults, your spouse receives $15,000 plus one-half of the remaining estate, and the adult children divide the balance. If an adult child has already died, his or her children receive the adult child's share of the estate. If only children remain, the estate is divided among them. If your parents are living and you have no children, your spouse receives $15,000 plus one-half of the estate, with your parents receiving the balance. If you and your spouse have no children and your parents are not living, your spouse receives the entire estate. Others, such as brothers and sisters, grandparents, great-grandparents, and stepchildren, become eligible to inherit your estate if your spouse, children, and/or parents are not alive. If you have no living heirs, the money will be paid to the local board of education.

Dying without a will may be fine if no disagreements between parents and siblings arise. However, what if one sibling who has been working on the farm wants to continue to do so, while the other siblings want their share immediately? Because of the principle of equal treatment under the law, the farm may have to be sold. Having not written a will, the decedent therefore has no say over the disposition of the estate; the lack of a will can cause disagreements and the result may be an outcome no one would have wanted.

For example, if Marge and Bill die at the same time without leaving a will, their three children, Jane, Tom, and Mark, will inherit the property equally. If both Jane and Tom want to farm the property but cannot agree on a partnership, they may end up splitting the land into parcels. In addition, they must be able to purchase Mark's share of the land. A bank may not be willing to lend Jane or Tom enough money to buy out Mark; even if they qualify for a loan, Jane and Tom will be carrying a debt load as they begin farming. Marge and Bill could have written a will leaving the land to Jane and Tom and leaving other assets to Mark; or, alternatively, the parents could have set up a different arrangement that would be fair to all the children and that would also help to ensure the farm's continuity and its cash flow.

Willing the Farm to Your Spouse

Farm owners can will shares of their farms to their spouses tax free. Therefore, no matter what the value of the estate, a spouse may inherit it without incurring any federal estate tax liability. The act of willing your share of the farm to your spouse, in itself, however, is not a long-term solution for minimizing estate tax. Taking advantage of the unified tax credit is. When surviving spouses die, the size of their estate is greater. The estate includes both spouses' shares of their property. Because tax rates gradually rise, the portion of the estate that belonged to the first spouse to die will actually end up being taxed at a higher rate.

Taking advantage of the unified credit is one of the most effective estate-planning techniques. Each person in a couple is able to take the full unified credit. If Andrew and Beth Jamison die together and pass their farm valued at $1.35 million to their children, each can use the unified credit of $220,550 to exempt $675,000, for a total of $1.35 million. Thus, the full value of the farm will be exempted from estate tax. If, however, Beth dies first and passes her share of the farm to Andrew, no estate tax will be owed because of the marital deduction; when Andrew dies, however, only one unified credit can be used. Nine months after the date of Andrew's death, estate tax will be due on the remaining $675,000 of the estate.

How to Hold Title to the Property

The ownership structure of the property will determine the ease with which each partner can use the unified tax credit. Many farmers operate as sole proprietors; others operate as partners with their spouse, and husband and wife own their property as joint tenants with survivorship. Assets owned through a partnership will pass automatically to the living joint tenant without tax, and, as mentioned above, the unified credit for the decedent cannot be used. However, if spouses each hold sole title to part of the assets or hold the assets as tenants in common, part of the assets can be transferred to heirs other than the spouse and both unified credits can be used. Other forms of business organizations such as limited partnerships and corporations may also facilitate transfer of the farm and allow children who do not participate in the farm's day-to-day management to earn returns from the farm.

As an example, Judy and Keith jointly own a 200-acre farm with rights of survivorship. The farm is worth $1.2 million and they own $150,000 in other assets. When Judy dies, the farm automatically passes to Keith even though her will has established that assets be distributed to other heirs so that she can use her unified credit fully. With the land in joint ownership, sufficient assets are not available to allow full use of the credit. The credit is only applied to Judy's half of the $150,000 in other assets. To ensure the full use of unified credit as a planning tool, Judy and Keith also needed to look at the best way to hold title to their property.

Consult a professional estate tax attorney or accountant to determine the most beneficial manner of owning your property and passing on the business to heirs.

Trusts

Trusts, which are useful in estate planning, are legal methods of owning property; the trust appoints a trustee as the manager. Several kinds of trusts, such as bypass trusts and living trusts, are used in estate planning. For full information, you will need to consult an accountant or attorney.

The contents of your will determine how your property is dispersed after your death, but having a will does not mean that your heirs will avoid the probate procedure. When you die, someone must file your will with the registrar of wills and a probate estate is opened. During this sometimes lengthy process, the court ensures that all of your debts are paid from the proceeds of the estate before approving distribution of the remaining property to the beneficiaries delineated in the will. As probate is a public process, all probate information is publicly available.

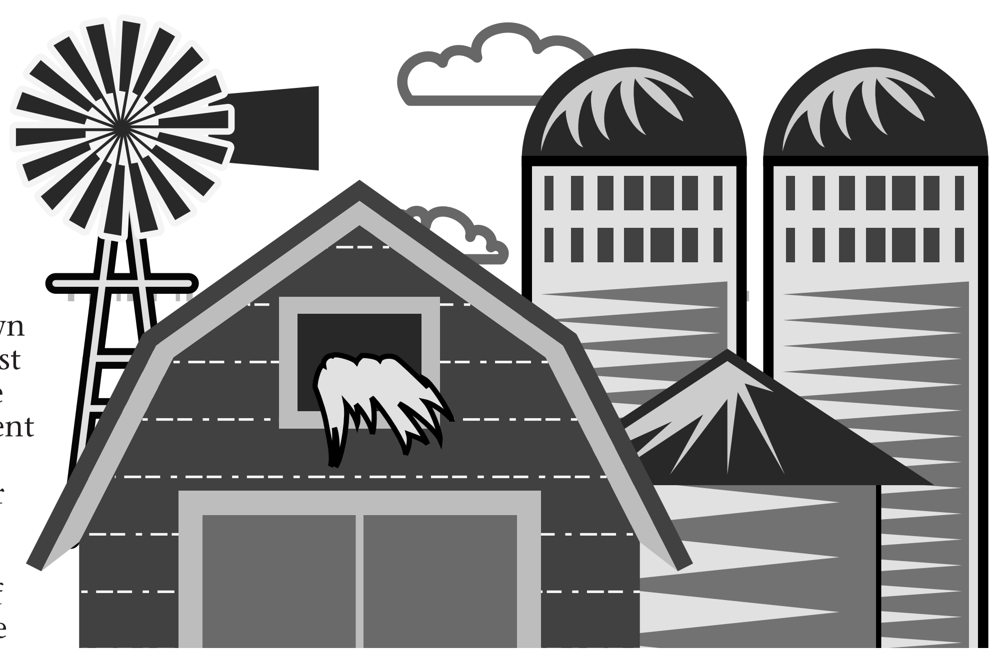
Living Trust

If you create a living trust with you as the trustee, you can avoid the probate process for those assets titled in the trust. You continue to have ownership rights over the titled assets, but you must designate a successor trustee. Your successor, who takes over the ownership of the trust, can pass it to the heirs. You can also draft a trust that gives the successor trustee the right to take over in the event that the original trustee becomes incapacitated because of dementia or some other debilitating condition.

Bypass Trust

A bypass trust transfers a beneficial interest in the assets to the living spouse, but not the ownership of the assets. This kind of trust is useful for couples who want to be assured that the assets remaining will be sufficient to support the surviving spouse. With a bypass trust, the surviving spouse can have access to the income and, if desired, the principal, but both members of the couple can each use their full federal tax exemption. The maximum amount in assets that can be protected from tax in a bypass trust is the exemption amount. For the couple to minimize tax at the time of the first spouse's death, any excess above the exemption amount must pass to the surviving spouse, either outright or in another, separate trust.

For example, Bob and Mary Smith have a farm worth $1.35 million when Bob dies. His half of the estate, valued at $675,000, is transferred to a bypass trust. During her lifetime, Mary is able to use the income from the whole farm, including the half covered by the trust. However, she does not own the assets titled in the trust and cannot dispose of the farm without the agreement of the trustee. Upon her death, Mary passes on her half of the estate to her children, using the federal estate tax exemption of $675,000. In addition, the trustee turns over to the children Bob's half, which was held in trust for them; Bob's assets are free of federal estate tax, regardless of the value of the property at Mary's death.



QTIP Trust

Instead of making an outright marital bequest, you can create a "qualified terminable interest property" (QTIP) trust. Under the QTIP trust, the living spouse is paid the income from the trust funds, with the deceased spouse having named the beneficiaries who will receive the assets after the death of the surviving spouse. You can also use a QTIP trust in combination with a bypass trust for this purpose.

Gifting

Every person can make gifts of up to $10,000 to others every calendar year without incurring any gift tax. If any one gift is more than this amount, you have to pay a gift tax or use a portion of the unified credit. Once you give a gift, though, you cannot get it back. The $10,000 ceiling is now indexed to inflation, and thus is likely to rise over the years. Before making the gift to a third party, you should verify the amount of annual exclusion allowed in any given year. Gifts can reduce the size of large estates and therefore the estate taxes. Gifts of farm property must always be assessed at fair market value. Do not use this method if you may need all your assets to support your retirement.

Transfer of Ownership

If a family knows that the farm will be transferred after the death of the owner, one way to reduce estate taxes and achieve other goals is to complete part of the transfer before the owner's death. The heir and possible new owner buys parts of the farm, land, livestock, or equipment. The ownership of these assets can be transferred along with a parent-financed or current owner–financed mortgage to aid the new farmer. The family can place the business in a partnership or limited liability company (LLC) under which each parent gives the offspring a yearly gift worth $10,000, either in cash, equipment, livestock, or land, without incurring any gift tax liability. The family can also set up a corporation with shares that can facilitate the transfer of ownership. Each parent can transfer $10,000 worth of shares every year without incurring any gift tax liability. And upon the death of each parent, the excluded amount ($675,000 for 2000) can be transferred to the heirs with no tax burden if each parent owns separate shares. In addition, the value of the gifted property can be reduced by discounting since the recipient does not control the property and cannot easily sell this minority interest in the family farm. A discount of between 20 and 40 percent of the value of the gift property is readily allowable.

For example, George and Abigail Lewis have one son, Henry, who wishes to take over the farm. He begins by purchasing pieces of their equipment, which transfers ownership. His parents, who decide to transfer the farm through shares, set up a subchapter S corporation with one share for each acre in the farm. George and Abigail must retain the bulk of the stock—in their case, 80 percent of the initial shares—in order to keep control over the farm. George and Abigail can each gift Henry shares equal to $10,000 ($20,000 total) each calendar year without incurring any gift tax liability.

If the 300-acre farm has a fair market value of $1.5 million or $5,000 an acre, normally George and Abigail can gift up to four shares of the property (or $20,000) to Henry each year without incurring any gift tax liability. The IRS recognizes, however, that four shares of property have less value than $20,000, because owning these shares gives Henry little control over property decisions and he cannot sell his shares easily. Therefore, George and Abigail can actually give Henry more than four shares each year. As mentioned above, discounts between 20 and 40 percent of the value can often be taken. Thus, Henry can receive shares with an actual underlying value of $25,000 to $33,333 each calendar year, even though the gift is valued at $20,000. However, with annual gifts equal to $25,000, it will take his parents 60 years to gift the entire 300-acre farm, assuming it does not continue to increase in value. The extent of this time indicates the importance of planning and beginning this process at the earliest date possible. With the exemption amount of $675,000 for each parent, or $1.35 million for both, this process could minimize the farm's estate tax.

Life Insurance

Under circumstances in which a family is land rich and cash poor, life insurance can provide the cash needed to pay estate taxes. Even if part of a farm is to be sold, the cash a life insurance policy can provide to pay taxes gives family members time for seeking the best buyer rather than being forced to sell on short notice. Life insurance can be used to pay for the attendant expenses of death such as debts, taxes, and funeral costs. In addition, a family can use the proceeds from the policy to provide nonfarm siblings with their share of the estate without having to sell the farm. However, life insurance can be expensive, depending on the insured's life expectancy. In *Holding Our Ground*, Daniels and Bower estimate that a $1 million policy for a healthy couple aged 60 would run almost $25,000 a year for 10 years.

Although you do not have to pay income taxes on proceeds of your life insurance policy, the money is added to your estate's gross value unless you change the name of the policy owner. For example, you could give your daughter the money to purchase the policy on your life. Or you could choose to form an irrevocable life insurance trust

(Crummey Trust) on your own life. A trustee is named, who will pay the premiums and disburse the proceeds; the insured has no powers of ownership. Although the trustee is technically the beneficiary of the policy, the children, for example, can be named beneficiaries of the trust. A trust may be drafted in which the beneficiary—who can be the spouse and/or the children—is paid interest on the proceeds; at the insured's death the principal passes on to the children and other heirs.

Special Use Valuation

Reducing Fair Market Value

Internal Revenue Code Section 2032A, the "special use" valuation, offers an estate tax advantage to families who plan to continue farming for at least 10 years after the landowner's death. Under this section, farmland can be valued for estate tax purposes at its agricultural use value, which is often lower than its full market value. Section 2032A allows families to reduce the fair market value of their land by up to $750,000. If the property is jointly owned by a couple, each spouse can take the deduction, permitting up to $1.5 million to be exempted from estate tax liability. This amount is now being indexed to inflation, so it will be adjusted each year. The farm must be passed on to the spouse or other family member, known as a qualified heir. If the family stops farming the property before the end of 10 years, a recapture provision requires that the family pay the estate tax based on the property's full market value plus interest.

To be eligible for the special use valuation, the family must elect to take the valuation within 9 months of the landowner's death. In addition, at least half of the estate must consist of real or personal property, which on the decedent's date of death was being used for farming by the decedent or a family member. At least 50 percent of the estate must consist of farm assets (land, buildings, animals, or equipment). In addition, at least one-quarter of the estate must consist of real property such as farmland or other type of farm real estate, which was passed from the decedent to a qualified heir. This real property must have been owned and actively farmed by the decedent or a family member for 5 of the 8 years prior to the owner's death. Thus in 2006, a family that plans to continue to farm the land for the 10 years that follow will need to pay estate tax only on the portion of the estate that exceeds the $1 million exempted, coupled with the special use valuation of up to an additional $750,000. If both spouses take maximum advantage of the benefits, they can pass on up to $3.5 million to their children without incurring federal estate tax liability.

In certain cases, families have chosen to use this valuation only on part of the estate. This allows some property such as buildings and livestock to be sold without invoking the recapture provision.

Basis

Aside from the 10-year recapture provision, the biggest drawback of electing to use this special use valuation is that the heir is not able to receive a "step-up" on the basis of the farm property. Often the farm's original purchase price was an amount much below the farm's current value; the result is that significant capital gains taxes will be due on profits from the sale of land or other assets. The family can increase the basis of the farm when calculating the value of the estate. If the original purchase price of the farm was $500 per acre and now the farm is worth $1,200 per acre, the family can use the new value as the basis, avoiding the capital gains tax on the difference between sale and purchase price, or $700 per acre. This stepped-up basis is beneficial if you are planning to sell the property. However, capital gains tax rates are only 20 percent while estate tax rates range from 37 to 55 percent. Thus a family needs to consider which will benefit them the most—a special use valuation or a lowered valuation. In many cases, utilizing the special use valuation can benefit a family much more.

Rent Land to Family Member

The Taxpayer Relief Act has a new provision that permits families to rent land to a family member for farming and receive a cash rent without risking recapture provisions. The IRS only considers renting to family members as material participation in the farm. Renting to a nonfamily member can result in having the IRS demand payment of estate taxes based on the land's full value rather than the agricultural value.

Special-Use Calculation

Under Section 2032A, the land is valued according to a formula based on a 5-year average of cash rent paid in your county of residence for land of the same soil quality. After subtracting the applicable property taxes, the amount is divided by an interest rate (the federal land bank loan rate). If a county cash rent amount is not available, the IRS may use state agricultural assessment values or comparable sales of farmland. In a rapidly urbanizing county such as Howard, a 100-acre farm can have a market value of $1.8 million but a use value of only $61,162. This amount is based on a rental payment of $54 an acre, a preferential property tax payment of $4 an acre, and a fixed-rate 20-year mortgage interest rate for farmland, as reported by the Central Maryland Farm Credit Association, of 8.175 percent.

Market value of 100-acre farm in Howard County: $1,800,000

Use value: (rent – tax)/interest rate: $50/.08175 = $611.62 per acre or $61,162

Family-Owned Business Exclusion

Another new provision of the Taxpayer Relief Act is a deduction from the value of the gross estate for a qualified family-owned business. A family that plans to continue in the family business for 10 years following the death of the owner and that meets the requirements can claim this exemption. The exclusion presented in Table 3 is reduced by the value of the unified credit. Therefore, the exclusion amount will be decreasing until 2006, but combined with the unified credit it will continue to permit the deduction of $1.3 million from the gross estate. According to the basic eligibility requirements, the business must be family owned and at least one family member must participate in running the business before and after the landowner's death. If the family sells or stops participating in the business before the end of 10 years, the estate tax plus interest will be recaptured from the family.

Lower Interest Rates

Heirs of family-held businesses can defer payments of estate taxes related to the business for up to 4 years and pay only interest on the tax. They also can pay the estate tax on the first $1 million in taxable value in installments over a 10-year period—beginning as late as the fifth year after the date of

Table 3. Family-Owned Business Exclusion under Taxpayer Relief Act of 1997

Year	Exemption Amount	Exclusion Amount
2000 through 2001	$675,000	$625,000
2002 through 2003	$700,000	$600,000
2004	$850,000	$450,000
2005	$950,000	$350,000
After 2005	$1,000,000	$300,000

death—at an interest rate of 2 percent. For any additional taxes owed on the remaining value of the business, the family can pay an interest rate equal to 45 percent of the rate the IRS charges for underpayment of taxes. For heirs to be eligible to make graduated payments, the business or farm must represent at least 35 percent of the estate's gross value. The family must actively participate in the business, which can have no more than 15 shareholders or partners.

Maryland Inheritance Taxes

Lineal Tax Exemption

In 2000, Maryland passed a law eliminating state inheritance taxes for lineal heirs and siblings. Lineal heirs are the decedent's parents, grandparents, spouse, children, stepparents, and stepchildren. A corporation qualifies as a lineal heir if all stockholders consist of lineal descendants or spouses of lineal descendants. Siblings are brothers and sisters of the deceased.

Collateral Tax Rate

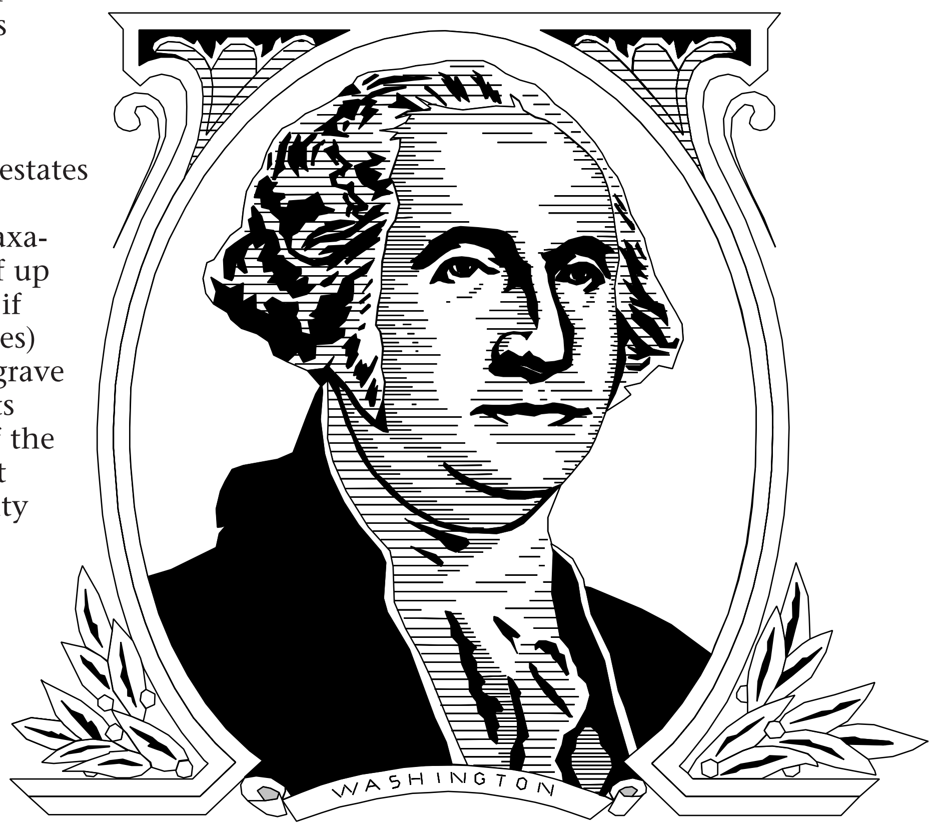
A tax rate of 10 percent is applied to all property passed on to other people and organizations that are not lineal heirs or siblings as identified in the previous paragraph.

Exemptions from Tax

Certain items and property from estates of individuals who died on or after January 1, 1998, are exempt from taxation. There is a funeral allowance of up to $5,000 (or an unlimited amount if the will or revocable trust so provides) as well as up to $500 for perpetual grave maintenance. Life insurance benefits that are not payable to the estate of the insured are exempted. The decedent can pass property tax free to a charity (Section 501{c}{3} organization) if incorporated in Maryland or if a reciprocal agreement exists, and to state, county, or municipal corporations. If the net value of the estate is $20,000 or less, the property can be transferred without any state inheritance taxes due. Any one individual can receive $1,000 without paying tax. In addition, if the estate generates any income gains or losses during the probate period, the estate does not have to pay inheritance taxes on the income, although income tax will be due on any gain.

An Ongoing Process

Although many of us think estate planning is a one-time process, the actual plan needs to be revisited from time to time, such as every 3 to 5 years, to ensure it continues to satisfy our needs and fulfill the goals we have set. In some cases, the farm will be passed on when the owner retires and disposition at death is not a necessary component of the estate plan; in others, the birth of a new child or grandchild might offer a reason for considering an alteration. In addition, new laws may be passed providing additional tools for facilitating the transfer of farmland with a minimum of tax impact. Remember, certain provisions such as the special use valuation must be utilized within a short time following death or they become unavailable. Therefore, you should determine which provisions are in the best interests of your family as circumstances change.



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