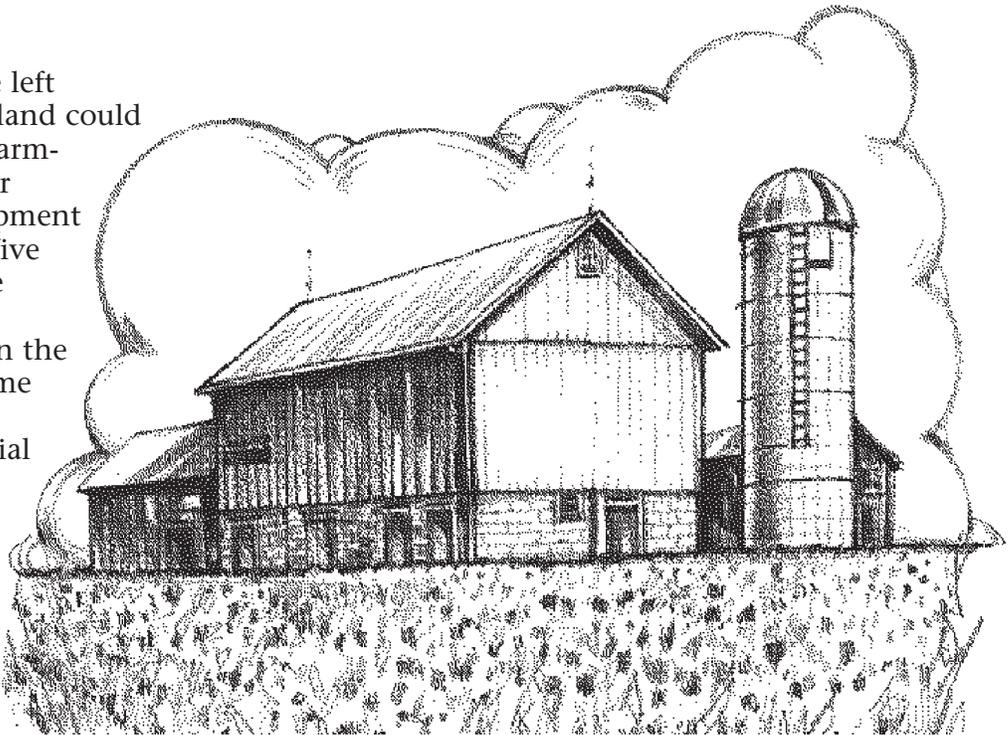


## Farmland Preservation An Estate Planning Tool

If current trends are left unchecked, Maryland could lose 500,000 acres of farmland, forests, and other open spaces to development over the next twenty-five years, according to the Maryland Office of Planning as reported in the Bay Journal. While some farmers choose to sell their farms to residential developers, in other cases farmland is lost because the owner dies and the family cannot afford to pay the estate taxes without selling all or part of the farm. All people who own real or personal property should invest time in estate planning. While few of us like to think about our eventual death, planning can ensure that we, rather than the state or probate court, decide who receives our belongings. Estate planning is particularly important for those farmers whose farm real estate value has increased dramatically. Without good estate planning, many farm families will be forced to sell the land in order to pay the estate taxes due. The



Taxpayer Relief Act of 1997 has provided new provisions that affect farm estate planning and can assist farm families in retaining the farm. This is particularly true if a farmer plans to donate or sell a conservation easement on his or her property.

This fact sheet presents several ways agricultural land preservation may be an estate-planning tool for your farm family. Agricultural preservation may assist you in avoiding excessive tax burdens and thus

**Table 1. Federal Estate and Gift Tax Rates**

Estate	Marginal Tax Rate	Federal Estate Taxes Owed <sup>1</sup>
\$ 675,000 or less	18-37%	0
\$ 700,000	37%	\$ 9,250
\$ 750,000	37%	\$ 27,750
\$ 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	\$1,070,250 + 55% of amounts more than \$3,000,000	

<sup>1</sup> The taxes owed apply to estates of individuals who died in 2000 and 2001. In future years, the amount exempted will increase and taxes owed will continue to decrease.

passing on the farm intact. Before deciding on preservation, though, you and your family need to set goals for your individual needs and desires and to determine your net worth. Once you have done this, you can determine the best planning strategy to achieve your stated goals. A general estate planning fact sheet, available through Maryland Cooperative Extension, is entitled, *Fact Sheet 778 Estate Planning: Farm Families and the Provisions of the Taxpayer Relief Act*.

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

## Federal Estate Taxes and the Unified Credit

Federal estate tax rates range from 37 to 55 percent.<sup>1</sup> 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 \$1,000,000, the marginal tax rate is 37 percent.

Currently, estates valued at less than \$675,000 owe no estate tax. Amounts greater than \$1,000,000 are taxed at marginal rates of 39 to 55 percent. As the estate value reaches \$3,000,000, the additional value is taxed at the 55-percent rate.

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. It comes in 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 a smaller portion of the sum of one's gross estate value and gifts to others is subject to taxation by the federal government. Gifts to others of more than \$10,000 a year<sup>2</sup> and the value of each person's estate are taxed by the federal government.<sup>3</sup> Each individual has the right to use a unified credit against these taxes.<sup>4</sup> For example, in 2000, estates worth \$675,000 or less can use the unified credit of \$220,550 to cover all the taxes due and not have to pay any money to the federal government. An estate tax return must be filed only for those persons whose gross estate exceeds the

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

<b>Year</b>	<b>Unified Credit</b>	<b>Exempted Amount</b>
2000/2001	\$ 220,550	\$ 675,000
2002/2003	\$ 229,800	\$ 700,000
2004	\$ 287,300	\$ 850,000
2005	\$ 326,300	\$ 950,000
After 2005	\$ 345,800	\$ 1,000,000

exempted amount. Table 2 shows the increases in the unified credit authorized in the Taxpayer Relief Act of 1997.

## Use the Unified Credit Fully

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 his or her will and property ownership are set up correctly. Each parent must have rights of ownership and transfer some of the property to the next generation rather than all to the surviving spouse. Andrew and Beth Jamison own a farm valued at \$1,350,000. If each own half the value, the share for each is \$675,000. While it is unlikely, if Andrew and Beth Jamison were to die at the same time, and pass on their farm to their children, they could each use the unified credit of \$220,550 to exempt their half of the farm's value which is \$675,000, for a total of \$1,350,000, from the gross estate for tax purposes. Thus, the full value of the farm could be exempted from estate tax.

If Beth were to die and pass her share of the farm directly to Andrew, no estate tax would be owed since Beth could give her share of the estate to her spouse tax-free under the marital deduction. When Andrew died, however, only one unified credit (Andrew's) could be used. An estate tax of \$268,750 would be due nine months after Andrew's death on the remaining \$675,000. Andrew and Beth would have saved their children \$268,750 by utilizing both unified credits.

## Conservation Easements and the New Tax Provisions

While using the unified credit helps reduce the estate tax burden, other considerations may apply. For example, the farm's value and thus the estate tax due could be greater than the unified credit or the family may need cash to compensate children who will not stay on the farm. Selling a conservation easement can 1) provide money to compensate nonfarming children, and 2) decrease the value of the land, thus the estate tax owed. You may wish to treat your children equally even if only one of them desires to stay on the farm. Because the estate's value is tied up in the land, you may have limited cash on hand to pass on to the nonfarming children. If the farm is divided evenly among all the children, the child taking over the farm may have to sell all or part of the farm to "buy out" the other siblings. The overall value of the farm may be too high for the child taking over the farm to do this without selling some land. This can result in a farm that is too small to support a family, or in no farm at all. Selling a conservation easement is one approach, which generates some cash from the land value while retaining the ability to earn a living through farming. Of course, you must consider estate-planning options for any cash received from an easement sale.

These conservation easements restrict the land from non-farm uses in most cases. To qualify for tax deductions, the conservation easements must be in perpetuity-that is,

apply to all current and future owners of the property. In the state of Maryland, there exist land preservation programs and land trusts that buy or accept the donation of a conservation easement on farmland property. The programs purchase the "development rights," i.e., the right to develop the land for residential, commercial, or industrial uses, and they require a legal attachment to the land title of the property. This attachment remains with the property even after the ownership has changed hands. Owners receive either a cash payment or the ability to take a charitable tax deduction due to a donation or bargain sale or both, and in return restrict the possible uses on the property. Any cash payment will be treated as a capital gain (minus any basis) in the year it is received. (For details on assessing the capital gains owed, please see the Maryland Cooperative Extension Fact Sheet 780 entitled, *Taxes and Land Preservation: Computing the Capital Gains Tax*.) By accepting the restrictions, the owner has most likely reduced the value of the property. In most cases, the new value of the land will be based on its value as a farm or large estate homesite.

The value of the property is based on the decreased value of the land due to the development restrictions. Therefore, if the McDonalds' land value falls from a market value of \$1,200,000 for 300 acres to \$800,000 for the property with a conservation easement, the family's estate tax on the land will be based on the \$800,000 value, which will minimize their estate tax burden. Similarly, the gift tax would be based on the value of the land with a conservation easement. Thus, if a parent wants to give the land to a child, the gift tax should be lower.

The value of the development rights is the difference between the land value in its "highest and best use" and its value with the conservation easement attached. Programs use different rules and procedures to determine the exact quantity of money they will pay owners for the rights. The difference between the appraised value and the payments received can be taken as a charitable



gift. For example, the Harris land has a fair market value of \$250,000 and a post-easement value of \$100,000, thus a conservation easement value of \$150,000. The land preservation program pays the Harris family part of this value to preserve the land, giving them a payment of \$100,000. Since the conservation easement value was \$150,000 and a payment of only \$100,000 was

received, the Harris family can take the other \$50,000 as a noncash charitable deduction on their income taxes. This can be done by filing a noncash charitable contributions form with the income tax return.

To qualify to take this deduction, the conservation easement must be in perpetuity, must be donated to a "qualified conservation organization," such as a land trust or an agricultural preservation program, and must satisfy the IRS's definition of serving a valid "conservation purpose." The IRS usually permits a landowner to deduct only 30 percent of his or her adjusted gross income in any one year.<sup>5</sup> The donation can be spread out for up to six years. For example, Mr. Harris could declare \$8,333 each year for a six-year period. Usually, the payment for the development right increases the family's income substantially. For example, since Mr. Harris has just received a payment of \$100,000 for the easement, which will be included in his adjusted gross income, 30 percent of the income just from the easement sale is \$30,000.

A recent change in estate tax laws gives landowners who donate an easement the right to exclude additional value from estate taxes. Farmland with a conservation easement attached to its deed may also exclude up to an additional 40 percent of the land value (given the easement) from the estate value if it meets the eligibility requirements. The maximum additional deduction is being phased in, as detailed in Table 3.

Qualifying land must be located in or within 25 miles of a metropolitan area, in or within twenty-five miles of a national park or wilderness area if the park is under significant pressure, or in or within ten miles of an urban national forest. Most of Maryland is

**Table 3. Additional Deductions for Conservation Easements**

Year	Exclusion Amount
1999	\$ 100,000
2000	\$ 200,000
2001	\$ 300,000
2002	\$ 400,000

eligible under this geographic restriction. In addition, the qualified conservation easement must reduce the value of the eligible land by at least 30 percent. If the reduced value of the land is less than 30 percent, only a smaller exclusion will be permitted. If the property has retained any right to develop the land (such as to build a house for the children), these rights will be taxed.

## Special Use Valuation

Farmers have an estate tax advantage in Internal Revenue Code Section 2032A: the special use valuation. Under the terms of this section, families who plan to continue farming for at least ten years can have the farmland valued at its agricultural use value, which is often lower than its full market value, for estate tax purposes. Special use valuation applies only to the land portion of one's estate.

Section 2032A allows one to reduce the fair market value of the land by up to \$750,000 for estate tax purposes. This amount is now being indexed to inflation, so it may be adjusted each year. If the property is jointly owned by a couple and both are passing on the land to the next generation, each spouse can take the deduction, permitting up to an additional \$1.5 million to be exempted from estate tax liability. 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 within ten years, a recapture provision requires that the family pay the estate tax on the full market value, plus interest.

To be eligible, the family must elect to take the valuation within nine 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 a qualified purpose such as farming by the decedent or a family member, and which passed from decedent to a qualified heir. At least 50 percent of the estate must be 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 passed from decedent to a qualified heir. This real property must have been owned and actively worked for a qualified purpose by decedent or a family member for five of the eight years prior to the owner's death. Thus in 2006, a family that plans to continue to farm the land for the next ten years need pay estate tax only on the portion of the estate that exceeds the \$1,000,000 exempted amount coupled with special use valuation of up to an additional \$750,000. If both you and your spouse take maximum advantage of the benefits, you can pass up to \$3,500,000 to your 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.

Aside from the ten-year recapture provision, the biggest drawback of using this special use valuation election is that the heir is not able to receive a "step-up" in the basis of the farm property. Often the original purchase price of the farm is much lower than its actual value, resulting in significant capital gains taxes owed if you or your heirs sell some of the land or other assets. After selling the land, a landowner would figure the capital gain tax on the difference between the selling price and the basis (usually the original purchase price plus additional improvements). If the basis is low relative to the selling price, the capital gains will be large, and thus so will the capital gain tax. If the family has the value of the property appraised at the owner's death and taxes are based on this newly appraised value, then the family

can increase the basis of the farm to that amount. 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 gain tax on the difference in the sale price and purchase price of \$700 per acre. This “stepped-up” basis is beneficial to minimize the capital gains tax owed 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 the family needs to decide whether electing to take Section 2032A or taking the stepped-up basis will be most beneficial. In many cases, utilizing the special use valuation can benefit a family much more than the lower valuation will hurt it.

The Taxpayer Relief Act added a new provision that permits the family to rent the land to a family member for farming and receive a cash rent without risking recapture provisions. Families cannot rent to nonfamily members, as the IRS does not consider this to be material participation in the farm, and can result in the IRS demanding payment of estate taxes based on the land’s full value rather than the agricultural value.

Under Section 2032A, the land is valued by the five-year average of the county cash rent for land of the same soil quality minus the applicable property taxes, then is divided by an interest rate (the federal land bank loan rate). In the case where a county cash rent amount cannot be found, the IRS may use the state agricultural assessment values or comparable sales of farmland. Thus, in a rapidly urbanizing area like Howard County, an 100-acre farm can have a market value of \$1,800,000 but a use value of only \$61,162.<sup>6</sup>

## Selling a Conservation Easement When Farm Is Under IRS Code 2032A

The Taxpayer Relief Act attempts to clarify whether donating or selling a conservation easement on the property while in the ten-year period triggers the recapture provisions. The amendment states that a qualified conservation easement by gift or “otherwise” is not disposing of the farm, and should not result in recapture. There remains some need to qualify the “otherwise”—for example, if the family sold a conservation easement after electing 2032A and received a cash payment from the Maryland Agricultural Land Preservation Foundation, would this trigger the recapture provision? This has not been tested in court yet. Although not a final ruling, in one court decision the judge added a footnote stating that the new provision does not apply to easement sales for which the landowner received a payment.

## Family-Owned Business Exclusion

Another new provision of the Taxpayer Relief Act is a deduction from the value of the gross estate of an adjusted value of a qualified family-owned business. A family that plans to continue in the family business for an additional ten years following the death of the owner and that meets the requirements can claim this exemption. The exclusion presented in Table 4 is reduced by the value of the unified credit. Therefore, it will be decreasing until 2006, but combined

**Table 4. Family-Owned Business Exclusion under Taxpayer Relief Act of 1997**

Year	Exemption Amount	Exclusion Amount
2000/2001	\$ 675,000	\$ 625,000
2002/2003	\$ 700,000	\$ 550,000
2004	\$ 850,000	\$ 450,000
2005	\$ 950,000	\$ 350,000
After 2005	\$ 1,000,000	\$ 300,000

with the unified credit it permits the deduction of \$1.3 million from the gross estate. The basic eligibility requirements include that the business be family-owned and that at least one family member always participates in running the business. If the family sells or stops participating in the business within ten years, the estate tax plus interest will be “recaptured” from the family.

## Lower Interest Rate

Heirs of certain family-held businesses can defer payments of the estate taxes related to the business for up to four years, paying only interest on the tax. They also can make installment payments of the estate tax due for the first \$1 million in value (after the application of the exemption amount) over a ten-year period, beginning as late as the fifth year after the date of the 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 IRS rate for underpayment of taxes. The business or farm must be at least 35 percent of the gross estate value to be eligible for graduated payments.

The family must actively participate in the business, which can have no more than 15 shareholders or partners.

## Ongoing

Although many of us think estate planning is a one time process, the actual plan needs to be revisited from time to time (every three to five years) to ensure it continues to satisfy our needs and fulfill our goals. In some cases, the farm will be passed on when the owner retires, and therefore disposition at death is not a necessary component of the estate plan. In other cases, the birth of a new child or grandchild might require an alteration. In addition, as can be seen from the Taxpayer Relief Act, new tools can appear to facilitate the transfer of farmland with a minimum of tax impact. Certain provisions such as the special use valuation must be utilized within a short period of time following death or it may be unavailable. Therefore, evaluating whether this provision is in the best interest of the family as circumstances change helps to be able to make this determination without delay.

## Notes

<sup>1</sup> 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 percent, which as of 2000 is imposed on estates larger than \$675,000.

<sup>2</sup> This \$10,000 limit is now indexed for inflation, rounded down to the nearest \$1,000. Thus it is likely you will be able to gift more than \$10,000 in future years.

<sup>3</sup> Some gifts can exceed \$10,000 without facing the gift and estate tax. These include 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.

<sup>4</sup> All gifts since 1976 that exceed the annual limit are subject to estate tax. A taxpayer can use the unified credit to cover this tax even before death.

<sup>5</sup> If you are willing to accept certain limitations, such as limiting total deduction to the basis in the easement, you may elect to deduct up to 50 percent of your adjusted gross income.

<sup>6</sup> This assumes a cash rental payment of \$54 an acre and a preferential property tax payment of \$4 an acre. The calculation uses the fixed rate 20-year mortgage interest rate for farmland as reported by the Central Maryland Farm Credit Association.

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