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Farm Transition: Tough Tasks at Hand and Why Transfer Tax Isn't so Tough

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Dec. 31, 2012 was an important date relative to federal tax law. This date represented the return to prior laws affecting all of the major tax schemes in the United States: estate tax, gift tax, income tax, and Social Security tax. With passage of various laws for the primary reason of stimulating the economy since 2008, tax law was viewed as temporary. The temporary nature of these tax laws increased uncertainty within the business sectors of the United States economy. Agricultural producers, as members of the primary production sector, faced challenges in managing the tax obligations of farm and ranch businesses. One such challenge, transition planning of family farm businesses, was filled with uncertainty as December 31, 2012 approached.

The passage of the *American Taxpayer Relief Act of 2012* (ATRA 2012) on January 2, 2013, settled, for now, the transfer tax uncertainty facing businesses of all sizes, and in particular closely-held family businesses of which the family farm or ranch is one type. This article attempts, from a farm management viewpoint, to provide perspective as to how American agriculture can now focus on the often-difficult tasks and decisions within the transition planning process of moving assets and management from one generation to the next. Tax schemes are discussed individually as to their impact on the transition process.

Brief Overview of Transfer Tax Legislation Since 2001

Passage of the *Economic Growth and Tax Relief and Reconciliation Act of 2001* (EGTRRA) began over a decade's long tinkering with tax schemes. Transfer estate, gift, and Generation Skipping Taxes (GST) were one area of taxation that was addressed in EGTRRA. This legislation provided, for ten years, the increase of the estate exclusion amount from $675,000 in 2001 to $3.5 million per estate in 2009 and ultimately a one-year repeal of estate and GST taxes in 2010. By 2007 the estate exclusion amount had grown to $2 million and the tax rate on taxable estates dropped from 55% (with a 5% additional tax for estates above $10 million) to a flat tax rate of 45% on the taxable estate. EGTRRA provided that in 2010, both the estate tax and the GST would be repealed for one year. However, conventional thinking was that Congress would have sufficient time to address the one-year repeal and craft permanent legislation for estate, GST, and gift taxation.

The gift tax exclusion amount rose and became fixed at $1 million and became decoupled from the estate tax exclusion amount in 2004, with the estate exclusion amount rising to $1.5 million that year. For the period 2004 to December 31, 2009, transfer tax schemes were no longer unified and property owners and planners dealt with increasing complexity to accomplish business transitions. In 2010, bones were thrown—first, the gift tax rate was reduced to 35%; and second, the GST was repealed for this one year. With the repeal of the GST, a one-year window was opened for transfer of business assets to grandchildren by grandparents, for example, without GST, and only the gift tax to consider.

Jan. 1, 2010 arrived and with it the repeal of estate taxes and GST. This repeal was unexpected by many professionals in the field. One such expert, Neil Harl, during the question and answer period following his address at the American Agricultural Law Association's annual meeting in Williamsburg, Virginia in September, 2009, expressed confidence that repeal would not occur. Harl predicted that

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Congress would act to prevent repeal and provide a measure of certainty for the citizens of the United States before the end of 2009 (van der Hoeven, 2009).

After nearly a year of increasing angst, Congress passed and the President signed, at nearly the eleventh hour, *the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act* (TRA 2010) on December 17, 2010. TRA 2010 broadly affected all of the tax schemes in place (including income taxes, Social Security taxes and the estate, gift and generation-skipping taxes) and created the temporary nature of U.S. taxation, as the sunset date of December 31, 2012 was established.

TRA 2010 reunified the estate tax, gift tax and GST exclusion amounts with a reset to a new higher exclusion amount, $5 million dollars per individual beginning in January 1, 2010. Additionally the Act set a new flat tax rate of 35% on estates, gifts and generation-skipping transfers exceeding the new exclusion amount. TRA 2010 allowed for indexing of exclusion amounts to inflation and beginning with 2011, the exclusion amounts were $5 million (2010 & 2011). In 2012, the inflation index increase was $120,000; therefore the 2012 exclusion amount was $5.12 million for estate tax, gift tax and GST. Further, and most powerfully, TRA 2010 allowed for "portability" of the federal estate tax exemption between married couples. This allows married couples to effectively transfer $10 million dollars of assets, transfer tax free, through their estate plans for 2011 and $10.24 million in 2012. However, portability between spouses was not allowed for the GST.

To circumvent possible Constitutional issues, TRA 2010, allowed executors the choice to have the repeal of the estate tax, per EGTRRA, apply without step-up to fair market value (FMV) of assets in the estate created in 2010 or the new $5 million dollar exclusion amount with step-up of assets to FMV. Decedent's estates that were valued significantly above $5 million might well benefit from this option, if assets were expected to be held by the heirs. The trade-off for these large estates is one of basis. For large estates to benefit from the repeal, carry-over basis was applied to the inherited assets. One notable death was that of George Steinbrenner, owner of the New York Yankees, who died in the summer of 2010. Reportedly, Mr. Steinbrenner's estate was in excess of one billion dollars.

The *American Taxpayer Relief Act of 2012* quelled this uncertainty when it became the law of the land on January 2, 2013. A fuller discussion follows regarding how ATRA 2012 affects business transition planning. The removal of this uncertainty regarding transfer tax law allows for the possibility by owners of farms and ranches in the United States who are planning estates and the transition of agricultural businesses to address and make the more difficult decisions.

Federal Estate Tax in 2013 under ATRA 2012

ATRA 2012 made permanent (or as permanent as any law may be until Congress picks up the issue again) the question of the "tax-free estate". ATRA 2012 provides that an estate has, in 2013, an exclusion amount of $5.25 million dollars. This "tax-free estate" is actually a function of the estate tax credit amount; the credit is the tax that would have been paid on $5.25 million. In public discussion, the "tax-free estate" is an easier concept to convey. Additionally the Act allows for an annual inflation adjustment, therefore, the exclusion amount will continue to increase. With high commodity prices land values have risen recently. This inflation adjustment in the estate exclusion amount may help mitigate the potential of becoming a taxable estate due to appreciation in value of land owned by farms and ranches.

A further benefit of ATRA 2012 is the allowance of married couples (as defined under the Defense of Marriage Act) to potentially utilize the full $10.5 million (2013) between the two individual estates. The portability provision allows for the unused portion of the first-to-die's estate to transfer to the surviving spouse. This election was made permanent by ATRA 2012. Executors/administrators of estates of the first spouse to die make the election to move the unused estate exclusion amount to the surviving spouse by timely filing a federal estate tax return, IRS Form 706, even if the estate of the first to die owes no federal estate tax.

Because individuals can shield $5.25 million in 2013 ($10.5 million for married couples) from estate taxation, it is estimated that more than 99% of all estates will now escape this transfer tax (Harris, 2013). However, farmland owners should be aware that location near urban areas, as well as ownership of many acres of land, may place them in this top 1% to 2% of estates. Transition planning for this possibility is obviously recommended for these landowners.

The "step-up" to fair market value of decedent's assets was retained by ATRA 2012. The fair market value is determined by a qualified appraiser as of the date of death of the decedent, or the alternate date six months after death as found in Internal Revenue Code section 1014. This step-up is part of the process in calculating a decedent's taxable estate; but has potential income tax consequences for heirs. The important issue, for the heir, not the decedent, is that this stepped-up value becomes the tax basis for these assets in the hands of the heir after transfer from the decedent's estate. Heirs should be aware of the income tax consequence of a subsequent sale of an inherited asset. The inheritance is income tax free to the heir. However, if the heir sells the inherited asset, the basis of that

asset will determine gain or loss upon the sale. For example, an heir who inherits a 40 acre farm with a FMV of $100,000 can sell the land the day following inheritance for $100,000 and owe no tax on the sale.

For taxable estates, the estate tax is a flat 40% applied on the taxable amount. This is up from 35% as it was in 2012, but less than the maximum 55% rate had ATRA 2012 not been passed.

IRC § 2032A allows for estates to elect to reduce the value of the estate of decedent if the estate consists of farm, ranch or timberland in a closely held business. The inflation adjusted amount for 2013 is $1,070,000. The IRS and the estate enter into an agreement that requires qualified heirs (typically family of the decedent) must hold the property for 10 years following the agreement and to retain the use of the property in the same activity as the decedent. Using this election allows farm families to protect up to $11,570,000 for a married couple ($10,500,000 + $1,070,000). Likewise, spouses who own land jointly or individually may also make the election separately; therefore a total tax-free transfer may be $12,640,000. The planning issue here is using alternate valuation of business assets, which might be considered in a large taxable estate.

IRC § 2031(c)(2) allows for a reduction in value of farmland for estate tax purposes if land in the estate is subject to a conservation easement. The maximum reduction in value is $500,000. Using conservations easements is a powerful tool for the reduction of taxable estates of land owners as the development rights are a significant value in the land. The easement may be placed on the land prior to death by the owner or by the executor under powers granted in the estate documents. Also, heirs once they control the land can also make the same election to use a conservation easement thereby reducing their estate value. Therefore, farm and ranch estates of married individuals might be able to pass up to $13,640,000 to their heirs without paying estate taxes, if both spouses use alternate valuation and have separate conservation easements ($10,500,000 + $2,140,000 + $1,000,000). Single individuals can similarly transfer $6,820,000 ($5,250,000 + $1,070,000 + $500,000).

IRS may allow owners of an ongoing business, such as a farm, to pay any estate tax at a modest interest rate over a period of time, up to 15 years. Section 6166 of the Internal Revenue Code provides guidance to executors of estates that have an estate tax liability.

Federal Gift Tax in 2013 under ATRA 2012

Federal tax law allows exclusion amounts for annual gifts and life-time gifts given to donees which can be used in farm and ranch business transition planning. ATRA 2012 once again unified the estate tax and the gift tax, thus the lifetime gift exclusion amount is $5.25 million (2013) and is inflation adjusted like the estate exclusion amount. The gift tax rate is a flat 40% on the taxable portion of a gift, up from 35% in 2012. In actuality it is the credit, estate and gift taxes that were unified, thus creating exclusion amounts of equal value.

The annual gift tax exclusion is $14,000 for 2013. Using the annual gift tax exclusion provides for incremental transfer of property to any donee the donor desires. Any gifts using the annual exclusion or less do not count towards the use of the unified credit. Formation of various entities such as an LLC or Sub-chapter S corporation may allow for ease in such annual transfers as it is ownership interest of the entity not physical assets that are given. IRS allows for lack of marketability discounts and minority discounts to apply to such transfers. As a result, more value can be transferred from one generation to another. IRS generally has allowed a 15 to 20% discount for each type, thus allowing a 40% total discount to be employed. Doing so facilitates transfer of approximately $20,000 to $23,333 of value from one party to another.

Farmers and ranchers have the ability to transfer by gift to successors, farm or ranch land, equipment and livestock gift tax free up to the lifetime gift exclusion amount applicable (plus the annual gift exclusion amount) for the year of the gift. Spouses may join their life-time gift exclusion amounts for a total of $10,500,000 in 2013. Federal law presumes the use of life-time gifts when gifts exceed the annual gift exclusion amount. Gifts are valued at fair market value (FMV) at the time of the gift. When donors make gifts, not only are they transferring the asset, but also the asset's tax basis and the donor's holding period. Basis in a gift does not step up to FMV at the time of the gift. If the item is held for less than one year this is deemed to be a short-term period; and if more than a year, is deemed to be a long-term period. The donor's holding period is tacked onto the holding period of the donee beginning with the date of the completed gift. This is important for the donee, should a decision be made to sell the gifted asset after the gift is complete—because if the holding period is long-term, the sale may be preferentially treated as a capital gain sale with a lower rate of tax applied to the gain.

However, two issues must be understood by donors; first the gift must be a complete gift whereby the donor gives up all rights to the assets given away. Secondly, that for every lifetime gift dollar given, the estate exclusion is reduced dollar for dollar. Therefore, if a person makes a life time gift of $3,000,000 and dies with a $5,000,000 estate at the time of death, for the calculation of estate

tax, the gift is pulled back in with the result of an $8,000,000 estate. Thus, in 2013, this would create a taxable estate with tax applied to $2.75 million.

Federal Generation Skipping Tax in 2013 under ATRA 2012

ATRA 2012 provides that the Generation Skipping Tax (GST) has the same inflation adjusted exclusion amount, $5.25 million, as do estates and life time gifts. IRS imposes the GST to prevent both decedents and donors from "skipping" a generation, generally their offspring, and allowing grandchildren, for example, to inherit or receive a gift without the government's opportunity to tax the middle generation. Again, the uniformity in the exclusion amount between these three transfer tax schemes: estate, gift, and GST allow for farm and ranch families to plan with a measure of certainty, regarding taxation, the transfer of assets of working agricultural businesses. The GST rate is 40% on any taxable GST transaction, which is up from 35% in 2012. The GST is applied on an individual estate basis. Portability of unused GST exclusion amount was not included as an allowable planning option under ATRA 2012.

Tough Tasks of Farm and Ranch Business Transition Planning and Execution

As discussed above, the "tax-free" transfer exclusion amounts are now known with certainty. Owners of farms and ranches can quickly calculate the potential transfer tax liability, if any, for 2013. With this knowledge, plans for management of any transfer tax can be made that minimize the economic and financial impact on the farm business. Owners now can focus on the more difficult decisions and planning processes of "who gets what and when", and when management of the business will be transferred.

Extension educators and other professionals engaged in helping business owners develop transition plans have long advocated a "sooner rather than later" mentality to the planning process. Farm and ranch business transition has been an educational program for decades with mixed results. The issue is real; David Kohl, professor emeritus at Virginia Tech, estimates that 70% of currently owned agricultural assets will transfer over the next 25 years. USDA's Economic Research Service reports 2012 estimates of total U.S. farm assets at $2.536 trillion and equity to be $2.268 trillion (USDA ERS). Using Kohl's estimate, $1.77 trillion in assets is expected to transfer from one generation to another over the next two and one half decades. That means nearly $71 billion per year, or $19 million per day of farm or ranch assets need a transition or succession plan to facilitate these transfers. USDA, in its *Status of Rural America*, reports that in 2007 the average age of the farmer was 58 years old. Transfer will happen; the question is will the transfer be planned and orderly?

Seemingly, the difficult issue is to relinquish control of a business in order for that business to grow. The financial pages of the *Wall Street Journal* or the *Investor's Business Daily* are populated with stories of companies that engage and plan for the succession of corporate board chairs, presidents, and senior officers in the executive suite. American agriculture might take a note of such intentionality. However, to be fair, most of production agriculture is closely held by sole proprietors, family partnerships, and companies that have family members as majority if not sole owners. Simply stated, there is family baggage in the family farm business. Quentin J. Fleming's book, *Keep the Family Baggage out of the Family Business*, is a transition playbook that is of value to any family business owner.

The significant hurdle of "the money issue" as it relates to transfer taxes has for the most part been settled by ATRA 2012. For many farm operators, the shock of "the number" was enough to forestall any serious planning effort; besides, the work of farming was far too much fun. Extension educators and other professionals have identified issues that may cause the planning process to be delayed; however, these must be overcome in order for family-owned businesses to have multi-generational success.

The "Ds" of Business Transition Planning

What follows is a discussion, based on observation and anecdotal application of nearly 25 years engaging to help families with the process of transition. The "Ds" of business transition can singularly or in concert derail the best of intentions. Possibly, these "Ds" are either in sight but out of mind; or they are the ultimate rainy day project, to be done when the owner gets "a round tuit". Four identified "Ds" are generally outside of the individual's control. Conversely, a second set of four identified "Ds" are within the purview of the individual.

Four "Ds" Over Which Individuals Have Very Little to No Control

Death is the first "D". Obviously, individuals generally do not know when the grim reaper might arrive. Individual owners should have an estate plan in place that provides a road map of their personal wishes as to the distribution of their property to beneficiaries. It is not uncommon for 50% or more of the attendees at a typical extension meeting to indicate they do not have an estate plan which was prepared according to their wishes. Therefore, these persons will be subject to the rules of intestate succession. The rules of intestate succession are crafted by the legislative bodies of the States. A fair question to raise is one that addresses the likelihood of

orderly transition of a going concern and to whom the assets ultimately belong. Generally, using rules of intestate succession yields less than optimal results for the continuation of farms and ranches because assets are distributed broadly among family. In North Carolina, for example, a surviving spouse with two or more children will inherit one third of the assets and the children the remaining two thirds of the estate of the decedent by these intestate rules. This type of division and distribution may well be the death knell of a family farm.

Obviously, having an estate document that provides for the income to go to a surviving spouse, but transfers working assets to the farm successor, may provide sufficient and equitable treatment of the next generation to operate the farm. Making those decisions about who gets what and when, takes consideration, care and resources to ensure long-term economic health of the farm business. If death stops the process of an estate plan, unintended consequences may result.

Disease is the second "D." As with death, individuals do not know if they may be struck with a chronic illness. The illness may lead to disability (discussed next) or death. Regardless, businesses should have contingency plans that facilitate the transfer of decision making, either for a period of time—so that the ill may focus on recovering health—or stepping completely out of the management of the agricultural business. Human nature may provide a false sense of security leading one to think; "that won't happen to me." However, what if it does indeed strike the owner-operator? A transition plan that allows for orderly answers to "if statements" with "then responses" can help to ensure that the family enterprise has a chance to survive.

Disability is the third "D". Disability can be sudden as in the case of a stroke; or, the disability may express itself increasingly over time as with Parkinson's disease. Physical disability may, in some instances, be overcome with assistive technology and the management capacity is still intact with the owner-operator of the farm. However, in the case of the loss of cognitive capacities, the physical labor and the management of the farm or ranch business must transfer to somebody else. A transition plan, which addresses this "D" can provide a solution for continuing success. However, again, the "that won't happen to me" scenario can delay the creation of an orderly transition plan.

Disaster is the fourth "D". It is generally beyond the control of the individual. Some argue that death and disability may be a part of disaster in the case of a serious farm accident or automobile crash. Commonly, insurance is used to mitigate disaster events such as fires, hurricanes, tornadoes and major accidents. Embezzlement may represent an economic disaster that may have far reaching consequences. Transition planning is part of risk mitigation with the owners and operators of businesses providing direction through an action plan to ensure, even in the event of a disaster, that the business can survive and thrive in the future.

Four "Ds" Over Which Individuals Have a Measure of Control

Disagreement is the fifth "D" in the total list; however, individuals have a measure of responsibility regarding personal reactions to a given issue. The response might be to engage with a simple, "Tell me more." Or, the response can be a full blown reaction with fisticuffs or worse. Disagreements between siblings may prevent parents from moving forward with plans to be fair regarding the transition scenario they envisioned; especially, if that plan is now turning into a disaster by their offspring's behavior. Often the question of fair is viewed differently between the husband and wife leading to an impasse. If this impasse is not resolved, progress on any plans to address important and vital questions to the long-term health of the family business is stopped dead. Long running disagreements can ruin even the best of transition plans should these disagreements remain hidden, only to come to the surface when a parent(s) dies. Ultimately, it is the owner's responsibility and obligation to make decisions regarding transition issues. However, with multiple generations working in farm and ranch businesses, the generations must overcome differences and begin the transition process.

Disengagement is the sixth "D", and may be substituted for denial. Disengagement can result from any of the other "D's" as the task of transition is viewed as overwhelming. A lifetime of building and accumulating assets, in order to grow a successful farm or ranch business, is now in stark contrast with the process of transition, the exiting of the business over time. Disengagement is a real threat to the transition process; business owners worry about fair versus equal, nonfarm versus on-farm heir, and a host of other equally important questions. Often, to disengage from the process is the easiest nondecision to make—to the detriment of the long-term success of the family and the farm.

Divorce is the seventh "D." Divorce is a fact of family life. Some marriages survive; others, for a variety of reasons, dissolve. Farm and ranch businesses are not immune from the possibility of such a family disruption. Prenuptial agreements are, in some cases, part of a transition plan to ensure that working assets remain controlled by the business and any legal claim in the future is dealt with in a preordained manner which causes the least disruption to the farm or ranch business. The request for the signing of a prenuptial agreement can result in family disharmony. This is especially true if the request is sprung on the unsuspecting bridal couple by

nonimmediate family members—although they may have ownership interests in the family business. The question has been raised by more than one person on the way to the altar; "Are we planning a divorce before we're married?" With second marriages becoming more common in the rural setting, the case for a transition plan, coupled with an effective estate plan, which provides for a second spouse while protecting the children of the first marriage, is important and takes energy and thoughtful consideration. However, the complexity of the task becomes a disincentive to the development of a transition plan to move management and ownership to successors in an orderly manner.

Debt is the final "D" in this list. The accumulation of debt coupled with the untimely death of a farm or ranch operator may stymie a transition. When comparing the aggregate U.S. farm assets and farm equity numbers, discussed above, readers can surmise that U.S. agriculture is extremely solvent with a debt to asset ratio of nearly 0.10. However, individual farms may well be leveraged and the debt amount may be an obstacle to overcome. A scenario may emerge in which off-farm heirs see the fair market value (FMV) of the farm and "want their share"; and cash is preferred. However, the farm may be expanding into new enterprises and have increased debt. The on-farm heir wants to continue with the farm or ranch expansion plans; however, this heir cannot bring the siblings to understand that they also share in the debt. And if the farm is to be split up—so will the debt. And ultimately, by splitting the farm, the transition may fail if the plan is for the on-farm heir to continue the business. Hopefully, the off-farm heirs gain a measure of understanding and possibly decide to allow the on-farm heir to go-it-alone lock, stock, barrel and debt to boot. Plans for transition of management and ownership of farm businesses that have debt must have a strategic plan to address the debt. Business entity selection may be one part of the solution. If the farm was a closely held corporation, the decedent's ownership is represented by the shares of stock. The debt, therefore, is corporate debt and is reflected in the equity of the shares of stock at the individual shareholders level.

Final Thoughts

Decisions and decision making, relative to individual family members and what to do with the assets acquired over time, are actually the biggest "Ds" and obstacle to creating the transition plan. Readers should have an appreciation of the exclusion amounts for the three transfer taxes that may be applied regarding farm and ranch transition. The exclusion amount of $5.25 million per individual is applicable to gift, GST and estate tax schemes. With this permanent exclusion amount, over 99% of all U.S. estates will not owe transfer tax at death. Because this burden or fear of such a tax is removed from the overwhelming majority, the more difficult issues—those represented, in part by the eight "Ds"—can be addressed to ensure orderly transition of working farms and ranches. The tough question is who gets what and when. Owners of farms and ranches, regardless of business entity structure, have an obligation and a responsibility to make estate and transition plans of their own design so that successors may enjoy the opportunity to continue the family legacy.

For More Information

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