Farmland
IN PERSPECTIVE

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GOODWIN

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# Estate Planning in a Climate of Change

***by Roger A. McEowen***

The Economic Growth Tax Reconciliation and Recovery Act of 2001 (EGTRRA) set in motion significant (but temporary) changes to federal transfer taxation and has had a significant impact on estate planning. Since then, Congress has attempted to make permanent the EGTRRA provisions. The EGTRRA provisions, and the more recent attempts to make them permanent, have created a climate of change that has made estate planning more difficult. Uncertainty in the law does that.

*The EGTRRA Provisions include:*

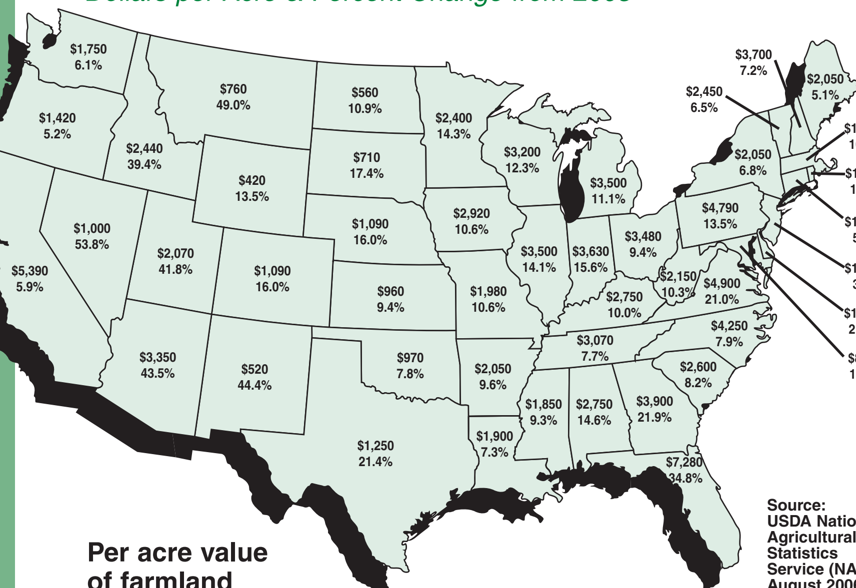
- The federal estate tax applicable exclusion rises, on a phased-in basis, to $3.5 million beginning for deaths in 2009.
- EGTRRA repeals the federal estate tax for deaths in 2010.
- At the same time, the maximum estate tax rate gradually is reduced, ultimately falling to 45 percent.
- The maximum gift tax rate falls at the same rate as the federal estate tax through 2009, but then is pegged at 35 percent for 2010 and thereafter.
- The gift tax exclusion is set at $1 million – that was effective for gifts made in 2002 and remains at that level.
- EGTRRA repeals the federal estate tax for deaths occurring in 2010, but then the tax returns for deaths beginning in 2011 with only a $1 million exemption and a 55 percent top rate.

*Continued on page 2*

**The following table shows the changes made by EGTRRA:**

| Year | Estate Tax Applicable Exclusion Exemption Amount | Estate Tax Applicable Credit Amount | Estate Tax Top Rate | Gift Tax Lifetime Exemption | Gift Tax Applicable Credit Amount | Gift Tax Top Rate |
|---|---|---|---|---|---|---|
| 2002 | 1,000,000 | 345,800 | 50% | 1,000,000 | 345,800 | 50% |
| 2003 | 1,000,000 | 345,800 | 49% | 1,000,000 | 345,800 | 49% |
| 2004 | 1,500,000 | 555,800 | 48% | 1,000,000 | 345,800 | 48% |
| 2005 | 1,500,000 | 555,800 | 47% | 1,000,000 | 345,800 | 47% |
| 2006 | 2,000,000 | 780,800 | 46% | 1,000,000 | 345,800 | 46% |
| 2007 | 2,000,000 | 780,800 | 45% | 1,000,000 | 345,800 | 45% |
| 2008 | 2,000,000 | 780,800 | 45% | 1,000,000 | 345,800 | 45% |
| 2009 | 3,500,000 | 1,455,800 | 45% | 1,000,000 | 345,800 | 45% |
| 2010 | Repealed | Repealed | Repealed | 1,000,000 | 345,800 | 35% |
| 2011 | 1,000,000 | 345,800 | 55% | 1,000,000 | 345,800 | 35% |

**2006 Farm Real Estate Value by State —**
*Dollars per Acre & Percent Change from 2005*




Source: USDA National Agricultural Statistics Service (NASS), August 2006.

**Per acre value of farmland**

USDA average as of January 1, 2006 (top number)
Percent change from January 1, 2005 (bottom number)
*U.S. Average – Dollar/Acre: $1,900 • Percent change from 2005: +15.2%*

# Farmland Values Continue to Rise

Nationwide, farm real estate values, a measurement of the value of all land and buildings on farms, averaged $1,900 per acre on January 1, 2006, up 15% from 2005. The $1,900 per acre is a record high and $250 more than a year earlier. Cropland and pasture values rose by 13% and 22%, respectively, since January 1, 2005. Cropland values averaged $2,390 per acre and pasture values averaged $1,000 per acre on January 1, 2006, compared with $2,110 and $820 per acre, respectively, a year earlier.

The increase in farm real estate values continues to be driven by a combination of mostly nonagricultural factors including relatively low interest rates and strong demand for nonagricultural land uses. Demand for farm real estate as an investment continues to be a strong market influence.

## *Food Stamp Program Helps Farm Economy*

The primary goal of the Food Stamp Program is to help low-income households buy the foods they need for a nutritionally adequate diet. Yet, the program serves another purpose: it increases the demand for food products and farm commodities and increases cash receipts for these sectors. Researchers at the Economic Research Service of the U.S. Department of Agriculture estimate that the additional food purchases resulting from each $1 billion of program benefits redeemed generates $97 million in farm cash receipts, which translates into 950 farm jobs and $32 million of income to farmers and hired farmworkers.

On average, each dollar spent on food by low-income shoppers generates 39.3 cents of farm cash receipts, though the magnitude varies by food items. Approximately 45 percent of the cash receipts goes to producers of crops, including feed for animals. The remaining 55 percent goes to producers of dairy, poultry, and other livestock.

***Estate Planning** cont. from page 1*

### *The Income Tax Basis Issue*

A key point in the EGTRRA changes that is often overlooked is that EGTRRA repeals the rule allowing a complete basis "step-up" in the hands of heirs for property included in a decedent's estate in 2010 – the year the federal estate tax is repealed. In its place, a rule of "modified carry-over" basis applies – up to $3 million basis step-up for property passing to a surviving spouse and $1.3 million of basis step-up for other property (to be allocated at the executor's discretion). The recent attempts to make the EGTRRA changes permanent would also eliminate the present "new basis at death" rule. That would have a particularly harsh effect on agricultural estates which typically contain a lot of low basis assets.

*Consider the following:*

**Example:** A farm couple married in 1940 and the husband worked as a hired man for a neighbor until World War II service was completed. After the war, the couple tenant farmed for 10 years. In 1955, using an inheritance from the husband's aunt, the couple purchased two sections of land for $125 per acre for a total purchase price of $160,000. The couple added improvements of $100,000, which were depreciated out by the time the wife died of cancer in 1992. Because the money to buy the farm came from the husband's aunt to him, the farm was considered the husband's so there was no adjustment of income tax basis at the wife's death in 1992. The husband dies in 2010 when the farmland is valued at $2,700 per acre for a total value of $3,456,000.

**Result:** The husband's estate would have $1,300,000 to increase the basis of estate property. If that amount is allocated entirely to the land, the income tax basis of the land would be $1,460,000 ($1,300,000 plus the basis at the time of death of $160,000). Yet the fair market value is $3,456,000. The difference is $1,996,000. Assume the two children, neither of whom is farming, sell the land for $3,456,000. The gain of $1,996,000 ($3,456,000 minus the basis of $1,460,000), assuming a combined state and federal capital gains rate of 20 percent, would result in income tax liability of $399,200. Had the husband died in 2009, one year earlier, the exemption of $3.5 million would eliminate all federal estate tax liability. More importantly, the heirs would receive a step-up in basis to $3,456,000 and there would be no income tax liability on sale. Therefore, the heirs would be better off by $399,200 under current law on new basis at death than under repeal of current basis rules and repeal of federal estate tax as is proposed.

**Note:** *The example illustrates two important points that proponents of permanent repeal overlook:*

1. The provision for a $3 million basis increase for a surviving spouse is of no benefit at the death of the surviving spouse
2. If the $1.3 million and $3 million allowances are exceeded, carry-over basis rules apply.

A related point is that every estate would have to maintain sufficient records to satisfy IRS as to basis. That is not required currently because of the rule that automatically adjusts basis to the date of death value.

### *How Burdensome is the Estate Tax on Land Estates?*

In short, the answer is "hardly at all." IRS data from year 2004 (when the exemption was $1.5 million) reveals that only 1.2 percent of all deaths for the year resulted in taxable estates. Of those estates, 69.9% were valued at less than $2.5 million. In addition, there were slightly over 1,000 taxable estates nationwide that listed farm property – to any extent whatsoever. The estimate for 2006 is that only 300 farm and ranch estates will have any federal estate tax liability (remember, the exemption is now $2 million per decedent).

### *Planning Guidelines*

*For those with larger estates that might face estate tax upon death, here are some key planning tips:*

1. Balance the estates during life between husband and wife
2. Make sure enough property is left at the death of the first spouse for the surviving spouse
3. Make sure to watch potential state death-tax liability (if applicable)
4. Check the estate plan more frequently.

### *What is Likely to Happen?*

*At this time, it looks likely that the Congress will not permanently repeal the federal estate tax. In June of 2006, the U.S. House passed a bill that would:*

- Set the estate tax exemption at 5 million (adjusted for inflation)
- Reduce the top rate
- Maintain the complete new basis at death rule.

A bill with these kinds of provisions likely will become law. That would be a good result for agriculture.

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## How Democratic Control of Congress May IMPACT You

The next two years might be much quieter on the tax front than the past five years as the new Congress does not have the votes needed to override a presidential veto.

The primary concern may be that many existing tax provisions are not a permanent part of the Internal Revenue Code. They require an affirmative act of Congress to continue or reinstate.

- In August 2006, the Pension Act made permanent some tax provisions created in 2003, but many remain in the Code for a short time period. The new leadership may have different priorities and may choose not to continue some non-permanent tax provisions.
- In May 2006, Congress enacted a one-year "patch" for the alternative minimum tax (AMT). If nothing happens, several million more taxpayers will face an AMT problem in 2007. That is a real concern, and the in-coming chair of the House Ways and Means Committee has stated that the AMT is a priority item for him.
- Almost all the renewable energy tax provisions for ethanol, bio-diesel, and other renewable fuels are temporary. Some expire after 2008; others after 2010. This makes the industry's viability dependent upon continued taxpayer subsidization.

In general, the new leadership will likely approach tax policy on a "pay as you go" basis. That contrasts with the policy of the past few years whereby a tax provision is enacted that has a negative budgetary effect with an offset to occur at sometime in the future. So, incremental changes are likely, but the economy will continue to drive tax policy. Tax breaks will be likely if the economy sours or the stock market dips.

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