Agricultural Implications of the American Taxpayer Relief Act of 2012

Walter J. Armbruster

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Keywords:Agricultural Business Transfers, Estate Tax, GST, Income Tax, Inheritance Tax

U.S. tax laws have been in a state of flux since 2001 passage of the Economic Growth and Tax Relief and Reconciliation Act of 2001 (EGTRRA). The ensuing decade was characterized by various limitations in deductions and exemptions affecting standard graduated taxes, as well as gradual changes in taxes affecting gifts, inheritance and business transfers to next generation owners. These provisions were particularly important to farm businesses where family wealth is often heavily tied in with the business. The provisions of EGTRRA were sunset in 2010 and included a one year repeal of estate taxes and Generation Skipping Taxes (GST) for 2010. A major concern for agriculture was that the sunset provision meant reversion to pre-EGTRRA exemption levels which would affect estates over $1 million. The original intent was that Congress would be forced to reexamine the tax laws before the end of 2009 to prevent these 2010 repeals from occurring and generally address gift, estate and GST taxation issues.

In the meantime, as the clock wound down on EGTRRA, the United States was embroiled in economic and financial turmoil. Attempts to recover from the “Great Recession” led to special temporary tax law changes, and Congress failed to replace EGTRRA before the 2010 repeals took place. The Congress then passed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 on December 17, 2010 which affected many of the taxes. However, it created a temporary situation with a sunset date of December 31, 2012. The uncertainty about what was to follow it created lots of concerns among taxpayers, especialy those involved with small businesses which included many farm businesses. The significant increase in land values and in machinery investments in recent years made the taxes surrounding intergenerational transfers particularly worrisome to many agricultural producers.

The American Taxpayer Relief Act of 2012 finally brought resolution to the situation as of January 2, 2013. It made permanent many of the provisions of the 2001 EGTRRA, repealed a number of sunset provisions contained therein, and permanently increased exemption levels of the Alternative Minimum Tax (AMT). But the 2012 Act did not extend the recession driven payroll tax cuts in effect for 2011-2012, thus effectively increasing tax rates for all wage earners and self-employed taxpayers starting in 2013. The articles in this theme outline the provisions of the 2012 Act and examine its implications of particular relevance to agricultural producers and rural land owners.

McEowan leads off with a broad review of the provisions contained in the Act and identifies those of greatest significance to agricultural producers and rural land owners.

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owners. These include tax rates, transfer taxes and the AMT. He goes on to address a number of other provisions extended from prior law which have potential implications for agricultural producers and rural land owners.

Durst points out that farmers and owners of other small businesses hold significant amounts of wealth in the form of business assets, and therefore may be subject to the Federal estate tax. Concerns about how this affects ability to transfer viable operations to the next generation has resulted in increasing exemption levels and special provisions targeting farmers and other small businesses owners. The American Taxpayer Relief Act of 2012 made the estate tax law permanent with a $5.25 million exemption amount (potential $10.5 million for married couples) for 2013, indexed for inflation in future years, and it provided for a 40% top tax rate. Durst examines how many farm households are likely to owe any Federal estate tax under the 2012 Act.

Van der Hoeven looks at the implications of the 2012 Act with particular attention to the planning opportunities created for transition of farm businesses as viable operating entities. By removing much of the uncertainty regarding transfer tax law, it opens the door for 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. He offers significant insights into the issues which often interfere with this critical management responsibility to maintain business continuity and viability.

In total, this set of articles provides a good overview of the implications for agricultural producers and rural landowners of the American Taxpayer Relief Act of 2012.

**For More Information**


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An Overview of Changes in the American Taxpayer Relief Act of 2012 Impacting Agriculture

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JEL Classification: H24, K34
Keywords: Estate Tax, Gift Tax, Income Tax, Transfer Tax

On Jan. 1, 2013, the U.S. Senate finally took up H.R. 8 which had passed the U.S. House on Aug. 1, 2012. The bill was received in the Senate on Sept. 10, 2012, and was placed on the Senate Legislative Calendar where it remained until Jan. 1, 2013. On Jan. 1, 2013, the Senate renamed the bill “The American Taxpayer Relief Act of 2012” (Act), made changes to the bill, passed it, and shipped it back to the House. The House approved the changes late on Jan. 1. President Barack Obama signed the legislation into law on Jan. 2, 2013.

The Act makes “permanent” key parts of the 2001 tax law, including a repeal of the sunset provisions in that law with respect to individual income tax brackets, and certain other income tax and transfer tax provisions. The Act also permanently increases the alternative minimum tax (AMT) exemption and reinstates some pre-2001 provisions.

The Act also contains significant tax increases, and did not extend the payroll tax cut that was in effect for 2011 and 2012. Thus, all wage earners and self-employed persons will see a tax increase in 2013. Specifically, the employee share of Social Security Old-Age, Survivors, and Disability Insurance (OASDI) for 2013 increases from 4.2% to 6.2% and the self-employed tax rate increases from 10.4% to 12.4%. For a taxpayer with wage and/or self-employment income at or above the maximum wage base of $113,700 for 2013, an additional $2,274 in tax liability results compared to 2012. For a typical family earning $50,000 in 2013, the additional tax will be $1,000. In 2013, most U.S. households, whether farming or not, will face the highest tax burden since 2008.

Major Provisions Affecting Agriculture

The Act contains numerous provisions that impact agricultural producers and rural landowners. Included in the provisions of primary impact are those that involve tax rates, transfer taxes, and the AMT.

Income Taxes

While the Act makes permanent the 2001 tax rates, it does impose a 39.6% rate on taxable income above $450,000 (married, filing jointly; and surviving spouses); $425,000 (head of household); $400,000 (single); and $225,000 (married, filing separately). The thresholds are indexed for inflation starting in 2014 (for tax years after 2013).

With respect to the new top bracket, a significant “marriage penalty” is imposed. For instance, married persons filing jointly or separately hit the threshold at $450,000, but two unmarried persons living together would each have their own $400,000 threshold.

In addition to the marriage penalty, the Act also contains provisions that cause taxes to increase at income levels beneath the thresholds. For example, the phase-out of personal exemptions starts at $300,000 for joint filers or surviving spouses. The phase-out starts at $275,000 (head of household); $250,000 (single); and $150,000 (married, filing separately). Once the applicable threshold is exceeded, otherwise available exemptions drop by 2% for every $2,500 (or portion thereof) that the taxpayer’s adjusted gross income exceeds the applicable threshold. The phase-out, however, does not apply to itemized deductions (investment interest, medical expenses, casualty or theft losses, and gambling losses), and is indexed for inflation for
tax years beginning after 2013. This provision is also inflation-indexed for tax years that begin after 2013. Likewise, the same thresholds apply to the phase-out of itemized deductions. Once the applicable threshold is exceeded, itemized deductions are given a 3% “haircut” with the reduction capped at 80% of the otherwise allowable itemized deductions. What all of this means is that taxpayers with incomes beneath the beginning of the 39.6% bracket will experience a higher effective tax rate.

Capital Gains and Dividends
Under the Act, the top capital gain and dividend rate rises to 20% for taxpayers with incomes exceeding the $450,000 threshold (married, filing jointly) and $400,000 for other taxpayers—those in the 39.6% individual income tax bracket. For these taxpayers, the actual capital gain and dividend tax rate is 23.8% due to an additional 3.8% surtax beginning in 2013 as a result of the 2010 Patient Protection and Affordable Care Act (more commonly known as “Obamacare”).

The zero percent capital gain rate is retained for taxpayers with ordinary income, taxed at an individual income tax rate of 10% or 15%. For taxpayers who are in the 25% to 35% tax brackets, the applicable capital gain rate is 15%.

Transfer Taxes
The Act, effective for transfers after 2012, establishes a $5 million (inflation-adjusted) unified credit exemption equivalent for estate, gift and Generation Skipping Transfer Tax (GST) purposes. For 2013, the inflation-adjusted amount is $5.25 million. For gift tax purposes, the present interest annual exclusion is set at $14,000 for 2013. That is the total amount that can be gifted outright to an individual in 2013 without the need to file a gift tax return.

Portability of the unused amount of the exclusion at the death of the first spouse is also retained and made permanent. With portability, the deceased spouse’s unused exemption equivalent of the unified credit (the deceased spouse’s unused exclusion amount) can be transferred by election to the surviving spouse. To make the portability election, IRS Form 706 must be filed in the estate of the first spouse to die, regardless of the size of the decedent’s estate, to make the election. Portability simplifies the estate planning process by eliminating the need to establish marital deduction wills for spouses, containing both a credit shelter bypass trust and a marital deduction trust. But, for those plans that have already established such trusts, there is no need to change the plan based on the Act.

The Act does increase the rate on transfers above the amount covered by the credit to 40%. Specifically, under the Act, transfers exceeding $500,000 are taxed at 37%. Transfers over $750,000 are taxed at 39%. Transfers over $1 million are taxed at 40%. Thus, with an exemption equivalent of $5.25 million for 2013, the unified credit is $2,045,800.

Permanent AMT Relief
While the AMT was not eliminated, the Act imposes a permanent (no sunset) increase in the exemption amounts that are then indexed for inflation retroactive to tax years beginning after 2011. The AMT exemption for 2012 is $78,750 (married, filing jointly); $50,600 for unmarried persons (single or head of household); and $39,375 for married, filing separately. The AMT exemption phases out at 25% beginning at an alternative minimum taxable income of $150,000, with a taxpayer fully phased out at $465,000 (married, filing jointly).

Income Taxation of Estates and Trusts
The Act eliminates the 35% rate bracket for the income of estates and trusts, and replaces it with a 39.6% rate bracket. The starting point for the new 39.6% rate is $11,950 for 2013.

Permanency of Personal Nonrefundable Credits
The Act makes permanent the Internal Revenue Code (I.R.C.) §§21-25D credits that offset both regular tax and AMT. Those credits include the household and dependent care credit, the credit for the elderly, the adoption credit, the child tax credit, the credit for non-business energy property, the residential energy efficient property credit, and the credit for interest on certain home mortgages.

Most Significant Extended Provisions
In addition to the major provisions affecting agricultural taxpayers discussed in the preceding section, a number of other provisions in the Act were extended from prior law and have potential implications for agriculturally related taxpayers.

Tax-free Distribution from an IRA to Charity
The provision allowing tax-free distributions (up to $100,000 annually) by individuals 70.5 years and older to charity is retroactively restored for 2012 and extended through 2013. Because the distribution is direct to the charity, the amount is not included in income and, therefore, avoids the applicable phase-outs and the 3.8% Obamacare surtax on passible income since the surtax is based on modified adjusted gross income. Thus, the provision is a benefit for taxpayers who don’t itemize.

Under the Act, a qualified taxpayer could elect to have a distribution that was made in January 2013 be treated as having been made as of December 31, 2012. Likewise,
an election can be made to treat any portion of an IRA distribution to the taxpayer in December 2012 as a qualified charitable distribution (up to $100,000) if it was transferred in cash after the distribution to an eligible charity before Feb. 1, 2013, and the distribution otherwise satisfies I.R.C. §408(d)(8)

**Depreciation Provisions**

First-year 50% “bonus” depreciation is extended through 2013 (and through 2014 for certain “long-lived” assets). The provision is based on the taxpayer’s calendar year and applies to “new” property where its original use is with the taxpayer, and the property has a cost recovery period of 20 years or shorter. The provision applies to light trucks or vans, including SUVs, built on a truck chassis if rated at 6,000 pounds loaded vehicle weight or less. As applied to autos and trucks, an additional $8,000 deduction is allowed for the year the vehicle is placed in service.

Expense method depreciation is retroactively reinstated for 2012 at the $500,000 amount (with a $2 million investment ceiling) and is extended at that level for 2013. This method allows an off-the-top depreciation allowance of up to $500,000 for the first year that a qualified asset is placed in service. The Act also extends for tax years beginning before 2014—in conjunction with clear IRS pronouncements on the matter—the ability to make or revoke an expense method depreciation election on an amended return for an open tax year. IRS auditors are allowing the process of making as well as revoking an expense method depreciation election on an amended return in audit, and the IRS is successfully processing such returns.

It should be noted that this is a huge opportunity for taxpayers, especially if they are planning to sell an asset in 2013 on which they claimed expense method depreciation at an elevated level in a prior year for which the return remains within the statutory timeframe to amend (generally the previous three years). Revoking the election on such an asset on an amended return and making it on a different asset which will not be disposed of will restore basis in the item being sold, and minimize income tax and depreciation recapture.

Also, the Act reinstates for 2012 and extends through 2013 the ability to utilize expense method depreciation for up to $250,000 (as part of the overall limitation of $500,000) of qualified real property (qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property). For example, if a taxpayer puts in service during the tax year $500,000 worth of qualified property, $200,000 of which is qualified real property, $300,000 of expense method depreciation is available for “normal” expense method property that is also placed in service during the tax year.

The ability to treat certain types of qualified real property (qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property) as 15-year Modified Accelerated Cost Recovery System (MACRS) property—the current U.S. tax depreciation system—is retroactively reinstated for 2012 and extended through 2013. Since qualified leasehold improvement property was reinstated for 2012, it is eligible for 50% bonus depreciation if placed in service in 2012 or 2013 under the special rule that applies to it under the bonus provision. As noted above, all three categories qualify for up to $250,000 of expense method depreciation.

**Small Business Stock Gain Exclusion**

Restored for 2012 and extended through 2013 is the ability to exclude all of the gain on the sale of I.R.C. §1202 stock. This provision is designed to spur investment in small businesses. The stock must have been acquired after September 27, 2010. A five-year holding period must be satisfied and the corporation—taxed at the corporate level (except for certain types of C corporations)—during the holding period.

**Employer Tax Credit for Hiring Certain Employees**

The Act restores the Work Opportunity Tax Credit (WOTC) for nonveterans for 2012, and extends the credit through 2013 for both veterans and nonveterans. To get the credit, the employer must file IRS Form 8850 that certifies employment, to the appropriate state agency within 28 days of the hire date. Under the WOTC there can be employees from targeted rural areas whose hiring can make the employer eligible for the credit

**S Corporation Built-in Gain Tax**

For tax years beginning in 2012 or 2013, the recognition period for built-in gains—which represent the appreciation of asset value while the assets were in a C corporation—of an S corporation is a five-year period beginning with the first day of the first tax year for which the corporation was an S corporation (one which is not taxed at the corporate level). During that recognition period, C corporations that elect S status are subject to a 35% tax on built-in gains during the recognition period. Thus, for S elections effective January 1, 2007, or earlier, gains recognized are not subject to the built-in gain tax.

Also, S corporations that sell assets in 2012 or 2013 and report the built-in gain from those sales under the installment method where the sale occurred after the end of the five-year recognition period—but not before the end of the 10-year recognition period—the gain reported is not subject to the 35% built in gains tax.
Principal Residence Debt
For 2013, the provision allowing the discharge of a qualified principal residence debt to be excluded from income (up to $2 million) is available, as is the provision allowing mortgage insurance premiums to be deducted as qualified residence interest. The latter provision was also retroactively reinstated for 2012.

Energy-related Provisions
Numerous energy-related provisions were extended, including $12 billion in subsidies for the wind energy industry via the wind energy production tax credit. Other energy-related provisions applicable for 2013 include the energy efficient principal residence improvements credit ($500 lifetime), the credit for energy efficient appliances, the credit for energy efficient new homes, and a credit for 2- and 3-wheeled electric vehicles (electric bikes and scooters).

Education-related Provisions
The Act extends the American Opportunity Tax Credit through 2017 and applies it to the first $2,000 of qualified tuition and related expenses plus 25% of the next $2,000. Also, deductibility of student loan interest is no longer capped at 60 months, and Coverdell Education Savings Accounts are fixed at $2,000.

Revenue Raiser
As a revenue-raiser, for transfers after 2012, in tax years ending after 2012, plan provisions in a retirement plan such as a 401(k)) can allow participants to elect to transfer amounts to a designated Roth account. The transfer is taxed at ordinary income rates in the year of the transfer. Thus, the amount transferred will be treated as a taxable qualified rollover contribution with income tax due, but no penalty assessed.

Higher 2013 Taxes for All
The American Taxpayer Relief Act of 2012 made permanent some provisions of the tax code which had been the source of significant uncertainty for tax planning. Some of the provisions related to tax rates, transfer taxes, and the AMT are very significant for agricultural producers and rural landowners. But there are also a number of other changes that will be important benefits to them. Bottom line, however, all taxpayers and wage earners will face higher taxes in 2013.

For More Information
The Internal Revenue Code of 1986.

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The Effects of the Federal Estate Tax on Farm Households

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JEL Classification: H24, K34, Q14
Keywords: Assets, Farm Households, Estate Tax, Net Worth

Following more than a decade of uncertainty and changing exemption levels, the American Taxpayer Relief Act of 2012 made the estate tax law permanent with a $5.25 million exemption amount (potential $10.5 million for married couples) for 2013 and a 40% top tax rate. The exemption is indexed for inflation. At this level it is estimated that only about 0.2% of all estates will owe federal estate tax (Harris, 2013). However, the share of farm estates subject to the tax is expected to be slightly higher.

Farmers and owners of other small businesses hold significant amounts of wealth in the form of business assets and are thus more likely than other taxpayers to be subject to the federal estate tax. Concern for the impact of the federal estate tax on the ability to transfer the farm to the next generation has been a primary factor in increasing exemption levels and special provisions targeting farmers and other small business owners. The appreciation in land values and the rising investment in farm machinery and equipment have increased farm estate values. As of 2010, the median net worth of farm operator households was $576,745 (USDA, 2013), which is more than seven times the $77,300 median net worth for all U.S. households (Bricer, 2012). In fact, since 2000, average farm household net worth has nearly doubled (USDA, 2013). Farm net worth accounts for about 80% of average farm household net worth and farm real estate accounts for nearly 80% of total farm equity.

The impact of the new estate tax exemption levels can be estimated using information regarding farm assets and liabilities for farm operator households from the Agricultural Resource Management Survey (ARMS). Based on simulations using farm-level survey data from the 2011 ARMS, only about 1.4% of the 41,131 individual farm estates projected for 2013 are estimated to have assets in excess of $5.25 million and would be required to file an estate tax return. After deductions, only about half of these farm estates are likely to owe any tax. These taxable farm estates are estimated to have an average net worth of $11.2 million—including non-farm wealth—with the average taxable estate owing about $1.83 million for a total estimated federal estate tax liability of $524 million.

The impact of the federal estate tax varies by farm size. While the wealth of households associated with rural residence (small farms with a retired operator or a primary occupation other than farming) and intermediate farms (farms with sales less than $250,000 but a primary occupation of farming) has grown slowly since 2008, the wealth of households operating commercial farms (those with

Figure 1: Estimated Share of Farm Operator Estates With Tax Returns and Taxes, 2013

Source: USDA Economic Research Service estimate based on 2011 ARMS data.
sales of $250,000 or more) increased by 30 percent from 2009 to 2011. The different increases in wealth are primarily because commercial farm households own more farmland, which has appreciated rapidly in recent years (USDA, 2013). A relatively larger share of commercial farms is projected to owe federal estate taxes in 2013 (Figure 1). The average value of farm assets for commercial farms was roughly $2.9 million in 2011, based on the most recent data available from ARMS. Thus, despite the higher exemption levels and estate tax relief targeting farmland (special-use valuation), an estimated 7% of all commercial farm estates are likely to owe federal estate taxes in 2013. Commercial farms are 10 times more likely to owe federal estate taxes than other farms. While commercial farms represent only about 6% of all farm estates, they account for nearly 74% of all federal estate taxes paid by farm estates (Figure 2). In contrast, rural residence farms account for nearly two-thirds of all farm estates but only about 13.5% of federal estate taxes. These estates also tend to have a larger share of their net worth in nonfarm assets than commercial farm estates.

There is also variation in the effect of the estate tax by type of farm. While crop farms represent about 43% of all farms, they account for nearly two-thirds of taxable estates and over half of estimated federal estate taxes. In fact, crop farms involved in the production of high-value crops account for a large share of both taxable estates and federal estate taxes. These farms—which include those involved in the production of vegetables, fruit and tree nuts, and nursery and greenhouse products—are disproportionately represented among million-dollar farms and they produce over 70% of the total value of these high-value crops (Hoppe and Banker, 2010). Further, since these farms are geographically concentrated in the South and West, the share of estates that owe taxes also vary by region.

Figure 2: Estimated Share of Farm Estates, Estate Tax Returns, Taxable Returns and Taxes, by Farm Type, 2013

Source: USDA Economic Research Service estimates based on 2011 ARMS data.

Special Provisions Provide Added Tax Relief to Farmers

Concerns that estate taxes might cause the breakup of some family-owned farms and small businesses led Congress to include two special provisions in the Tax Reform Act of 1976. Over the years, these targeted provisions—the special-use valuation and the installment payment of estate taxes—have reduced the impact of federal estate taxes on farms with estates valued above the basic exemption. While increased exemption levels have reduced the need and the value of these special provisions, they will continue to provide significant benefit to the very large farm estates that exceed the new exemption level.

Special-Use Valuation of Real Property

The value of property for federal estate tax purposes is generally the fair market value on the date of the property owner’s death. However, if certain conditions are satisfied, the estate’s real property that is used solely for farming or another closely held business may be valued at the property’s value as a farm or business rather than at its fair market value. The method used to value farmland for use-value purposes is to divide the 5-year average annual gross cash or share rental for comparable land in the area, minus state and local real estate taxes, by an average of the annual effective interest rate for all new Federal Land Bank (FLB) loans for the year of death. For those farms that qualify, special-use valuation generally reduces the value of the real property portion of qualifying estates by 40% to 70%, with the largest potential reductions occurring for farmland near urban areas having residential or commercial development potential.

Based on information published by the Internal Revenue Service (IRS), the average reduction in value for qualifying estates in 2001 was 50%. The decline in interest rates since 2001 may cause the average reduction...
to be less than 50%. For estates of those dying in 2013, the tax law limits the special-use valuation reduction in value to $1.07 million. This limit is indexed for inflation. At the current 40% federal estate tax rate, the potential estate tax savings available under special-use value could be as much as $428,000. However, all or a portion of the estate tax benefits obtained under the special-use valuation provision must be repaid if the property is sold to a nonfamily member or if the property ceases to be used for farming within 10 years of the owner’s death.

Qualified Conservation Easement

Since 1998, there has been an added incentive to grant a qualified conservation easement on farmland subject to the federal estate tax. In addition to the reduction in the estate value of land for a conservation easement, an exclusion is provided for up to 40% of the value of land in an estate that is subject to a qualified conservation easement. The decedent or a member of the decedent’s family must have owned the land for at least three years prior to the date of death and the donation must have been made by the decedent or his or her family. The exclusion is based on the value of the property after the conservation easement is placed, and does not include any retained development rights to use the land for any commercial purpose except those supportive of farming. If the value of the conservation easement is less than 30% of the value of the land for purposes of the exclusion, the exclusion percentage is reduced two percentage points for each percentage point below 30%. The maximum exclusion is limited to $500,000. But at current rates, the exclusion alone can save an additional $200,000 in federal estate taxes.

Granting a qualified conservation easement is not treated as a disposition that would trigger the recapture of special-use valuation benefits, and the existence of a qualified conservation easement does not affect eligibility for special-use valuation. Thus, the exclusion can be used in combination with the special-use valuation provision. While the exclusion provides an additional incentive to donate a conservation easement, given the increased unified credit and the availability of special-use valuation, the number of landowners who are subject to the federal estate tax and who would benefit from the additional exclusion may be relatively small. Nevertheless, those farmers with very large estates and land holdings who are willing to forgo potential future development gains can reduce their taxable estate by not only the value of the conservation easement they donate during their lifetime but also another $500,000 without affecting the operation of the farm business. Because the maximum reduction is 40% of the value of the property subject to the conservation easement must be $1.25 million or more at the time of his or her death to get the maximum $500,000 reduction in the taxable estate.

Installment Payment of Estate Taxes

Federal estate taxes generally must be paid within nine months of the date of the property owner’s death. However, for certain estates with farm or closely-held business assets, estates taxes can be paid in installments. The installment payment provision was enacted out of concern that the heirs of family farmers and small business owners might have difficulty paying taxes on land and other relatively illiquid business assets. Under the provision, if at least 35% of an estate’s value is a farm or closely-held business, estate taxes may be paid over 14 years and 9 months, with only interest due for the first five years. In 2013, the interest rate on the first $1.43 million in taxable value (above the basic exemption and other exclusions) of the farm is 2%, with slightly higher rates owed on amounts above $1.43 million. Thus, the annual interest payment on this amount would only be $28,600. This installment payment provision, combined with the increase in the amount of property that can be transferred tax free, greatly reduces the liquidity problem that some farm heirs might otherwise experience as a result of federal estate taxes.

IRS Estate Tax Return Data Provides Additional Insight

An examination of actual federal estate tax returns filed in 2011 confirms that, compared to other taxpayers, a larger share of farmers are subject to the estate tax. Yet it also reveals that farm property is not a large part of the taxable estate, especially for larger estates (IRS, 2012). This should be expected since, compared to farm operators, these returns include those that may have reduced their involvement in the operation of the farm, reducing their ownership of farm assets through the gifting, or the sale or other transfer of farm property. This data also likely includes the estates of other individuals who owned some farm property at death but were never actively engaged in farming. Data regarding the type of property held by taxable estates suggests that publicly traded stock, state and local bonds, and cash assets are the largest holdings. While these assets are more liquid and may provide a ready source of funds to pay estate taxes, they can also affect the ability of estates to qualify for the use-value and installment payment provisions.

Of the 1,480 taxable estate tax returns filed in 2011, 228 or about 15% had some farm property in the estate, including farmland and other farm assets (Table 1). These estates reported an average of $2.162 million in farm property for a total of $493 million. Overall, this represented only about 2.5% of total assets for all taxable estates. While farm property represented about one-third of the total
estate for those estates less than $10 million, it represented only about 5% of total assets for those estates larger than $20 million. The average federal estate tax rate for estates with farm property was 15.5%.

The increased exemption levels and resulting lower effective tax rates—combined with the continued availability of special provisions, including the installment payment provision—should greatly reduce or eliminate any potential liquidity problems created by the estate tax on the transfer of the farm to the next generation. Thus, while a larger share of farmers will continue to be subject to the estate tax relative to the general population, over 99% of all farm estates will be exempt and those estates that are subject to the tax should have the resources to pay the tax without selling farm property.

### Table 1: Estate Tax Rates for Estates with Farm Property by Size of Gross Estate, 2011

<table>
<thead>
<tr>
<th>Size of Gross Estate (million $)</th>
<th>Returns</th>
<th>Farm Property</th>
<th>Average Tax Rate 1/</th>
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<tbody>
<tr>
<td></td>
<td>Number</td>
<td>Percent of All Returns</td>
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<tr>
<td>All</td>
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<td>15.4</td>
<td>493,009</td>
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</tbody>
</table>

1/ Average tax rate is average net estate tax liability as a percent of average gross estate for all estates in size category.

Source: Economic Research Service based on data from Internal Revenue Service, Statistics of Income Division, August 2012

### For More Information


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The views expressed here are those of the author and may not be attributed to the Economic Research Service or the U.S. Department of Agriculture.
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...
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 Hooven, 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
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 conservation 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 lifetime 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 detail 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
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

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.

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.

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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 where. 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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