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ESTATE PLANNING AND FARM TRANSFER IN A CHANGING LEGISLATIVE ENVIRONMENT: NORTH CAROLINA, U.S.A. AN EXAMPLE

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…Moving on,
They're here today, tomorrow they are gone;
When the bravest and the best
Of the boys you know "go west",…
A.B. "Banjo" Paterson

Abstract

Since the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, owners and operators of farms and ranches have opportunities to evaluate new estate planning strategies for the transfer of farm businesses to subsequent generations. However, with provisions of the Act to be phased in over several years, consideration must be given to having a "staged" estate plan. Under provisions of the current law, estate tax is repealed in the year 2010, but if Congress does not act, the legislation sunsets and returns to prior law January 1, 2011. This fact provides planning challenges for owners and operators of farms and ranches as the phase-in of provisions, the repeal in 2010, and the return to prior law relative to estate planning and business inter-generational transfer of property. This paper investigates the planning process and options available as they relate to a family-owned property in North Carolina, USA. Plans made must take into consideration the dynamics of a changing legislative environment, special-use valuation of land, opportunity cost of alternative uses for land, and off-farm heirs.

Introduction

Since enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) in the United States, owners and operators of farms and ranches need to evaluate and perhaps revisit estate planning strategies for the transfer of farm businesses to subsequent generations. EGTRRA provides for increasing amounts of wealth to be transferred to heirs without being taxed for federal estate tax purposes with full repeal of federal estate tax in 2010. However, EGTRRA sunsets (Dec. 31, 2010) and prior law returns (Jan. 1, 2011) restoring lower exclusion amounts and applicable credits. Further estate tax legislation, changes to current law or permanence of the law most certainly will occur in coming years offering land and business owners continuing challenges for planning with a measure of certainty. Owners of farm and ranch properties have an opportunity to develop estate and business transfer plans that allow for flexible options as statutory changes become enacted.

Discussion of estate planning includes three terms that are highly correlated, but need defining. These terms are: *tax rates*, *estate credit*, and *exclusion amount*. *Tax rates* are the percentage of tax assessed in a progressive manner to an estate. The *estate credit* is the dollar-for-dollar offset of estate tax under law to a maximum credit value in a specific year ($345,800[20] in 2003). Lastly, the *exclusion amount* is the "tax-free estate" that is generated by the estate credit in the year of death of the property owner. Often the terms "tax-free estate" and the *exclusion amount* are used interchangeably.

North Carolina is experiencing increasing land values in three predominant areas of the state. These areas: mountains to the west, coast in the east, and metropolitan areas in the center are experiencing rapidly rising land values. All land across the state of North Carolina has increased in value at an average annual rate of 8.35% since 1978. Locations with increasing development experience greater localized rates of growth. This increase in value can cause citizens to acquire, through appreciation, a taxable estate. Planning for the transfer of this land and other assets upon death should be undertaken to minimize the estate tax consequences.

Economic Growth and Tax Reconciliation Act of 2001

EGTRRA marks a major change in federal estate tax law. From the date of enactment to January 1, 2007 federal estate tax rates decrease and are reduced at the highest marginal rate of 60 percent to 45 percent. Table 1 illustrates the changes in highest federal tax rate (which is the only rate changed by EGTRRA) over the course of time until 2010. The 45 percent marginal rate is in effect as the highest rate for three years, 2007 – 2009. In 2010 the estate tax is repealed.

Table 2 illustrates the increase in the applicable exclusion amount (or commonly referred to as the tax-free estate) and the decoupling from gift taxes discussed later. Estates that escape the "death" or transfer tax grow in size until there is no estate tax in 2010. In 2002, a Congressional effort to make permanent the estate tax provisions of EGTRRA failed mid-year.

The estate tax is a progressive tax from the first dollar at a rate of 18% to the highest rate of 49% (2003). The applicable estate credit is a dollar for dollar offset on estate tax until used up. The exclusion amount (equal to the size of the estate that the estate credit covers) in 2003 is $1,000,000; no federal estate tax will be owed on taxable estates valued at $1,000,000 or less. On the 1,000,001th dollar the estate tax rate is 41% or $0.41. Over the period 2001-2009 with increasing amounts in the applicable exclusion amounts and the decrease in the marginal estate tax rates, a flat estate tax rate of 45 percent occurs initially in 2007 for estates valued greater than $2,000,000 and then in 2009 for estates valued greater than $3,500,000. These changes in estate tax rates and excludable amounts create planning challenges for farms and ranch businesses.

Table 1. Highest Marginal Estate and Gift Tax Rates: 2001-2011

Calendar Year	Highest Estate Tax Rate	Highest Gift Tax Rate
2001	60%*	60%*
2002	50%	50%
2003	49%	49%
2004	48%	48%

[20] All financial values are in U.S. dollars.

2005	47%	47%
2006	46%	46%
2007-2009	45%	45%
2010	Repealed	35%
2011 and on	60%*	60%*

* A 5% surtax in imposed upon estates valued in excess of $10,000,000. This surtax is in addition to the unified tax rates to a maximum estate value of $17,184,000, above this value, the marginal rate is 55%.

Table 2. Applicable Exclusion and Credit Amounts: 2001-2011

	Estate Tax	Estate Tax	Gift Tax	Gift Tax
Year of Death	Applicable Exclusion Amount	Applicable Credit Amount	Applicable Exclusion Amount	Applicable Credit Amount
2001	$ 675,000	$ 220,550	$ 675,000	$ 220,550
2002-03	1,000,000	345,800	1,000,000	345,800
2004-05	1,500,000	555,800	1,000,000	345,800
2006-08	2,000,000	780,000	1,000,000	345,800
2009	3,500,000	1,455,800	1,000,000	345,800
2010	Repealed	Repealed	1,000,000	345,800
2011	1,000,000	345,800	1,000,000	345,800

Planning

Estate planning is not a natural process. People must face their mortality and make decisions relative to the distribution of accumulated wealth. Typically, business owners desire to pass their assets on to the next generation so that the family enterprise may continue. Only persons that have estates with values in excess of $1,000,000 (in 2003) need to be concerned with estate taxes. But that does not preclude the need for estate planning. During fiscal year (FY) 2001, the Internal Revenue Service (IRS) reported that only 2% of estates owed estate tax. This begs the question then, why should the other 98% be concerned with estate planning or business transfer at death? Geographical areas that experience rapid growth in development also experience a growth in overall wealth leading to the necessity for estate planning; North Carolina is one such state. With a mountainous region in the west and a coastal area in the east attracting retirees and vacation and resort activities land values are being driven to new heights. Likewise, large areas of urban expansion in the middle of the state in three areas are underway: the Triangle, the Triad and Charlotte/Mecklenburg County. North Carolina citizens owning land that formerly was of low value are finding themselves with an accumulation of built-in gains due to appreciation coming from development pressures. This increase in wealth, from appreciation, has pushed these estates to values greater than $1,000,000 and they are now subject to estate taxation. Therefore, these property owners with recently taxable estates[21] need to engage in estate planning.

Basis

Basis for estate purposes is defined as either the cost (with adjustments) of an asset or its fair-market-value (FMV). Under current law, assets that are part of a decedent's estate are valued at fair market value as of the date of death. Thus, basis of an asset is changed upon the death of the decedent who owned that asset. For example, a rancher owned a tractor with an adjusted basis (for depreciation) of $15,000, the FMV of which was $45,000, dies and leaves his daughter the tractor. His daughter will inherit the tractor with a basis of $45,000 which is "stepped up" in this case from $15,000 to the FMV as of date of death. Under EGTRRA, assets are stepped up (or down) until the year 2010. In 2010 the "price paid" for the repeal of estate tax is that all assets no longer are stepped up to FMV but are transferred with "carry over" basis. "Carry over" basis is the basis of assets as if they were still in the hands of the decedent. However, the first $1,300,000 of the decedent's estate is stepped up to FMV. Additionally, $3,000,000 of assets may transfer to the surviving spouse and receive step-up treatment. Assets transferred with stepped-up basis are transferred by the executor at their discretion. This means that transfer planning must be done so that estates with values in excess of $4.3 million consider tax efficient strategies. With carry-over basis following some assets to the beneficiary, record keeping becomes important to any future transactions of these inherited properties.

Gifting of Property

EGTRRA increased the annual gift exclusion from $10,000 to $11,000 with a provision for future adjustments due to inflation. The donor may apply this exclusion to as many people (donees) as he/she desires. As part of a comprehensive estate plan, structured gifting may play a part in the transfer of business assets over time. Two central issues need to be dealt with concerning gifting; first, the loss of control and income from the asset given and second, with gifted assets the basis of the donor carries over to the donee. Donors, therefore, must be able to do with out the economic benefit of the gifted property. If business property is being gifted, likewise, the business must be able to do with out economic benefit of the gifted asset. The donee must record the basis of the gifted property received. Completed gifts are those where total transfer of all ownership and rights of the asset given go to the donee.

A planning tool enabling the splitting of estates between spouses is unlimited gifting between spouses. Spouses may make unlimited gifts during their lifetime to each other as well as upon death of the first spouse to the surviving spouse. Estate planners are able to use this tool to balance the estates of both husband and wife to maximize the estate tax savings. For example, if the wife owns several tracts of land which pushes her estate into one of taxable size, she can gift sufficient tracts to her husband so that her estate now falls below the taxable amount. The goal is to effectively shelter twice the exclusion amount for the married couple ($2,000,000 in 2003) and reduce estate taxes.

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[21] Agricultural land values average in the Tidewater $1,414 per acre, in the Mountain region $3,234 per acre (1998). Urban development land ranges (due to location) $15,000 to more than $850,000 per acre. Rural development land ranges from $5,000 to $15,000 per acre. Based on land alone, a taxable estate ranges from a little more than one acre to over 700 acres.

Prior to EGTRRA the estate and gift tax rates were unified and applied equally with the same exclusion amount but for the two purposes. The lifetime gift exclusion amount under EGTRRA is decoupled in 2004 when the gift exclusion remains and is capped at $1,000,000 and the estate tax exclusion increases to $1,500,000. The gift tax rates and exclusion amounts are illustrated in Tables 1 and 2, respectively. With the sunset provision of EGTRRA, the estate and gift tax rates become unified once more.

Special Use Valuation

Executors of estates have an option to value farm, ranch or small family businesses at special use value under Internal Revenue Code § 2032A. The size or value of the estate may be reduced when valuing farm or ranch assets by their productive capacity rather than their fair market value. Beneficiaries must maintain the assets in the same use for which special use value was determined for 10 years following the inheritance of the property. If the special use ceases prior to the completion of the ten year period, estate taxes that were not paid due to the special valuation are recaptured and paid. Special use valuation is capped annually for the purposes of reducing the value of the decedent's estate; for 2003 the cap is set at $840,000 and is adjusted annually for inflation. This limit is a tool that executors may use to reduce estate values and thereby any estate taxes owed. The limit is applied in the determination of the gross estate separately from the exclusion amount.

Alternate Date of Valuation

Executors of estates are also able to make use of a planning tool that allows for them to value the estate at an alternate date rather than the date of death. Generally, all the assets of the decedent are in the gross estate: stocks, bonds, personal property (equipment, cattle, grains, feedstuffs, etc), land, and home(s) and so on. These assets may be valued for alternate valuation purposes six months from date of death. Notably, over the course of time following the death of the decedent, some of these assets may change form. For example, corn stored in a grain bin may be either sold for cash or consumed as feed. An inventory should be prepared of all property as of the date of death so that these changes in form might be tracked. Should property, such as corn, be changed in form, the value on the date of change will be the assigned value for purposes of calculating the gross estate.

The use of an alternative valuation date is obviously beneficial should property held at the time of death incur a dramatic decrease in value. Financial assets such as stocks or bonds have experienced great volatility over the past 30 months. Likewise, a downturn in a real estate market might allow for the adjustment of commercial buildings and thereby the value of the gross estate by using the alternate date six months later.

Livestock born after the date of death as well as crops not yet "growing" are not allowed to be valued under the alternative date. Likewise, land valued under special use valuation is not included in property that is valued at the alternate date due to the allowance of special use valuation as discussed above.

Conservation Easements

EGTRRA made a technical correction to 1997 legislation, The Taxpayer's Relief Act (TRA), relative to conservation easements. The establishment of a conservation easement allows the executor to reduce the value of property to which the conservation easement is applied, by 40% up to a maximum of $500,000 for 2003 and beyond. The correction by EGTRRA was to include all land in the United States and its territories as eligible for this provision. Previously the land with the conservation easement had to be within 25 miles of a metropolitan area, national forest or wilderness area or within ten miles of an urban forest. The conservation easement must be in perpetuity and be monitored by an appropriate organization for compliance with the terms of the easement.

Thus, executors of estates gained another tool in two ways. First, if the conservation easement was in place at the time of the death then, the allowance for the reduction of property value is available. Second, TRA allows the executor to place real property under a conservation easement following the death of the decedent. The same reductions are then available to the estate.

For property holders putting a conservation easement into place while living provides for estate planning opportunities to the successive generations. The benefit of the 40% reduction in the value of land with a conservation easement passes to the estates of subsequent heirs as well. This proviso is not available to conservation easements established by executors of estates following death of the property owner.

North Carolina Estate and Gift Tax Provisions

The North Carolina Legislature repealed the Inheritance Tax effective January 1, 1999. The inheritance tax, a tax applied to the beneficiaries individually, was replaced with an estate tax. The estate tax is a "piggy back" tax to the Federal Estate Tax; the amount of the North Carolina Estate tax is equal to the maximum credit for state death taxes as allowed under Internal Revenue Code (IRC) § 2011 on the federal estate tax return. The liability for the estate tax is transferred (in principal) from the individual beneficiaries to the estate of the decedent.

With the increasing estate exclusion amounts from 2003 to 2009 and repeal of the Federal Estate Tax in the year 2010, North Carolina and other states that "piggy back" state estate taxes to the federal return are faced with the loss of significant revenue for the state. Farm and ranch owners must not only be aware of federal changes but the changes in their respective state laws can have tremendous impact on their plans for successful transfer of business property to the successive generation. Planning around federal and state changes is not a daily activity. However, it should certainly occur or be revisited on an annual basis to maintain or change estate and business transfer plans as legislation changes, in order to accomplish the goals of the property owner.

North Carolina did not increase the state's annual gift exclusion when the federal government did. For 2003 and beyond, North Carolinians are limited to $10,000 for tax free gifts to any donee. Therefore, farm and ranch owners using a strategic gifting program to transfer wealth need to be reminded of the difference in state and federal limits.

North Carolina: an Example

North Carolina with its population of over eight million residents makes up a little over three percent of the total U.S. population. In FY 2001, the U.S. treasury collected over 25 billion dollars in estate tax. In the same year, North Carolinians paid over 509 million dollars in estate tax, two percent of the U.S. total.

Development pressures are increasing land values in three major regions of the state: the coast to the east, the mountains to the west, and the metropolitan areas of the Triangle, Triad, and Charlotte/Mecklenburg County. Increasing land values pose planning problems in a changing legislative environment. Initially, EGTRRA provides for increasingly larger estates to escape taxation, however, with the sunset provision, and thus return of lower exclusion amounts farm, ranch and business owners are faced with legislative uncertainty along with the ultimate uncertainty of the owner's death. Furthermore, in the year 2010 executors are burdened with the responsibility to select assets of the estate that will receive a step-up in basis for that year only. If EGTRRA is made part of permanent law without changes then all future estates in excess of 1.3 million will need to make decisions as to what assets or properties receive step-up treatment.

Since it is generally desirous for a family business to be passed to subsequent generations so that the legacy may continue, recent changes in federal and North Carolina estate taxation make it easier to accomplish this goal. However, for some businesses, those that are greater than $4.3 million in size are faced with the issue of paying estate taxes in such a way as not to disrupt the activities of the business. Further, the state of North Carolina will face a shortfall in revenues if legislative changes are not made to adjust for the repeal in 2010 of federal estate tax and beyond.

Conclusion

This article has attempted to demonstrate the nature of a changing legislative environment with regard to estate taxation in the Unites States, using the state of North Carolina as an example. Farm, ranch and business owners do face challenges in the near term with the phase-in of legislative changes. Opportunities exist for the orderly succession of businesses to heirs. Executors have tools to use to help minimize the estate tax implications, but they also have responsibility to act competently in their fiduciary capacity. Provisions of EGTRRA allow for increasingly larger estates to escape taxation at the federal level. Should EGTRRA be made permanent, federal taxation becomes a non issue, however, local states that piggy back on the federal estate laws must replace the lost revenue. Thus, legislative changes and differences between state and federal jurisdictions provide new challenges to farm and ranch owners in the transfer of farm and ranch business assets.

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