University of Northern Iowa
UNI ScholarWorks

Honors Program Theses | Student Work

2013

The federal estate tax: a comprehensive look at the effects on American farming and ranching businesses

Taylor G. Johnson
University of Northern Iowa

Let us know how access to this document benefits you

Copyright © 2013 Taylor G. Johnson

Follow this and additional works at: https://scholarworks.uni.edu/hpt

Part of the Agribusiness Commons, and the Taxation Commons

Recommended Citation

Johnson, Taylor G., "The federal estate tax: a comprehensive look at the effects on American farming and ranching businesses" (2013). *Honors Program Theses*. 145.
https://scholarworks.uni.edu/hpt/145

This Open Access Honors Program Thesis is brought to you for free and open access by the Student Work at UNI ScholarWorks. It has been accepted for inclusion in Honors Program Theses by an authorized administrator of UNI ScholarWorks. For more information, please contact scholarworks@uni.edu.

Offensive Materials Statement: Materials located in UNI ScholarWorks come from a broad range of sources and time periods. Some of these materials may contain offensive stereotypes, ideas, visuals, or language.

University of Northern Iowa
UNI ScholarWorks

Honors Program Theses | University Honors Program

2013

The federal estate tax: a comprehensive look at the effects on American farming and ranching businesses

Taylor G. Johnson

Copyright 2013 - Taylor G. Johnson
Follow this and additional works at: http://scholarworks.uni.edu/hpt

This Open Access Honors Program Thesis is brought to you for free and open access by the University Honors Program at UNI ScholarWorks. It has been accepted for inclusion in Honors Program Theses by an authorized administrator of UNI ScholarWorks. For more information, please contact scholarworks@uni.edu.

THE FEDERAL ESTATE TAX: A COMPREHENSIVE LOOK AT THE EFFECTS ON AMERICAN FARMING AND RANCHING BUSINESSES

A Thesis Submitted

in Partial Fulfillment

of the Requirements for the Designation

University Honors

Taylor G. Johnson

University of Northern Iowa

December 2013

TABLE OF CONTENTS

1. CHAPTER ONE- INTRODUCTION
    a. Background, p.1
    b. Definition of a Farming and Ranching Business, p. 1
    c. Definition of the Federal Estate Tax, p. 2
    d. Research Questions to be Answered, p. 2
        i. Does the federal estate tax have adverse consequences on farming and ranching businesses in America?
        ii. If any reform is necessary, how should the federal estate tax law be modified?
2. CHAPTER TWO- HISTORY OF THE FEDERAL ESTATE TAX
    a. History of the Federal Estate Tax, p. 3
    b. The Debate Today, p. 7
3. CHAPTER THREE- PROPOSED LEGISLATION
    a. The Federal Estate Tax Law Today, p. 10
    b. The Scheduled Change on the Federal Estate Tax, p. 11
    c. Basic Example, p. 11
    d. Explanation of Example, p. 12
    e. Other Viewpoints on Federal Estate Tax Legislation, p. 14
4. CHAPTER FOUR- ISSUES WITH LEGISLATION
    a. "Permanent," p. 16
    b. Effects of Legislation, p. 17
5. CHAPTER FIVE- SPECIAL PROVISIONS
    a. Portability, p. 20
    b. Special use valuation, p. 21
    c. Family-Owned Business Deduction, p. 24
    d. Deferral of Federal Estate Taxes, p. 24
6. CHAPTER SIX- VARIOUS SCENARIOS
    a. No Planning, p. 28
    b. With Portability, p. 31
    c. With Special Use Valuation, p. 33
    d. Difference Between the Scenarios, p. 34
7. CHAPTER SEVEN- SCENARIO WITH VARIOUS LAW CHANGES
    a. Scenario 1: With the Current Law, p. 35
    b. Scenario 2: $1 Million Exemption, p. 36
    c. Scenario 3: $3.5 Million Exemption, p. 38
    d. Summary of Various Laws, p. 39
8. CHAPTER EIGHT- CONCLUSION, p. 41
9. LITERATURE CITED, p. 45
10. APPENDIX, p. 52

CHAPTER ONE- INTRODUCTION

a) Background

When a person passes away, all of his or her assets go into an estate. An estate is all the possessions of one who has died and are subject to probate (Grant 1). Before the assets are distributed to the beneficiaries of the decedent, a determination must be made as to whether a federal estate tax must be paid.

Many times, a decedent's estate will include a business that the decedent owned and operated. Often this is a family-owned farming and ranching business. Because the decedent owned the business, there is the possibility his or her estate will have to pay federal estate tax because the value of the business on the date of death of the decedent is included in the estate.

The federal estate tax has recently been a contested issue in the United States. There are various views on what to do with the legislation of the federal estate tax. With the current amount of federal estate tax exemption, some say thorough planning can allow for minimum impact of the federal estate tax on farming and ranching businesses in America. However, others say legislative uncertainty can make thorough planning difficult and could potentially harm farming and ranching businesses because of the lack of long-term consistency.

b) Definition of a Farming and Ranching Business

In order to properly look at the issue of whether or not farming and ranching businesses in America are affected, a basic definition of what a farming and ranching business is must be outlined. From the U.S. Small Business Administration (SBA)

website, a small business must be independently owned and operated, organized for profit, not dominant in its field, as well as subject to certain SBA size standards (What 1). These size standards are dependent upon the business industry.

In the agricultural industry, annual receipts may not exceed $0.5 to $9.0 million, depending on the product(s) being sold, to be classified as a small business (What 1). For the purposes of this thesis, a farming or ranching businesses will be one that has annual receipts between $0.5 million and $9 million and is the main source of income for the family. This standard gives a framework to look through for analyzing whether or not federal estate taxes have consequences on farming and ranching businesses in America.

c) Definition of the Federal Estate Tax

The estate tax is defined as the tax on the right to transfer property at death. Gross estate would include any assets owned at the time of death. This could be real estate, cash, stocks, bonds, businesses, and decedent-owned life insurance policies (SOI 1).

d) Research Questions to be Answered

One central divide that has emerged on the federal estate tax issue is whether or not it adversely affects farming and ranching businesses in America. An adverse effect on a farming and ranching business would be if business assets would need to be sold in order to pay the federal estate tax. There are opinions on both sides of this issue. Thus, the first research question to answer will be:

i. Does the federal estate tax have adverse consequences on farming and ranching businesses in America?

After a conclusion is drawn on whether or not there are adverse effects from the federal estate tax on farming and ranching businesses in America, it will need to be determined whether or not reform to the estate tax is necessary. A second research question will then need to be answered.

ii. If any reform is necessary, how should the federal estate tax law be modified?

In answering the above questions, a thorough discussion will be presented on the effect of federal estate taxes on farming and ranching businesses.

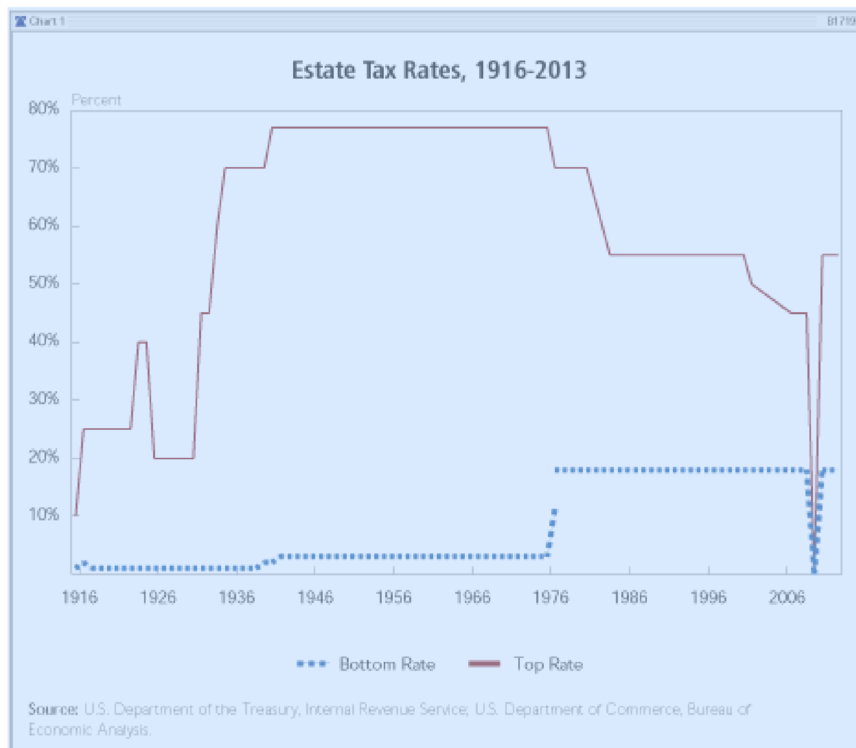
CHAPTER TWO- HISTORY OF THE FEDERAL ESTATE TAX

The federal estate tax has been a part of the tax system of the United States for a long time. Before looking into the debate today, a historical overview of the federal estate tax would be helpful.

a) History of the Federal Estate Tax

Originally the federal estate tax was used sporadically rather than consistently. The first time the United States used any form of federal estate tax was with the Stamp Act of 1797. With this Act, stamps were required on wills in probate. The tax revenue the government accumulated from this was used to pay off debts from war. However, the Stamp Act was repealed in 1802 (Robbins 1). This was not the last time a form of the federal estate tax would be used. When financing was needed again for the Civil War, a federal inheritance tax was put into effect. As before, when the war was over and there was no longer the financial need, the tax was repealed (Robbins 1).

The modern federal estate tax came about in the early 1900s. The Revenue Act of 1916 included a federal estate tax with components that are still used today. Two key components were introduced at this time. The first component was an exemption amount for an estate, which was set at $50,000. The second component introduced the escalated tax rate. This meant a lower tax rate was used for estates just over the $50,000 exemption, and then as the estate value climbed higher, the tax rate on the estate increased (Robbins 2). The following "Estate Tax Rates, 1916-2013" chart from the article "Estate Taxes: An Historical Perspective" from The Heritage Foundation's website shows how tax rates have changed since 1916. As shown, the federal estate tax rate has changed drastically over time.



Another major change in the federal estate tax came during the mid-1970s. During 1976, Congress combined the federal estate tax and gift tax credit to make them into one single credit. A gift tax is a tax on the transfer of property from one

living person to another (Robbins 3). This prevented people from taking advantage of both tax credits and closed a loophole in the tax system. This loophole allowed people to give away a maximum amount through the gift tax credit, as well as allowing a maximum amount of wealth to be passed on to their descendents. Thus, creating a unified credit prevented people from using both credits and lessening their estate value prior to death.

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) was passed in 2001. One of the purposes of this Act was to move towards eliminating the federal estate tax completely (Robbins 3). It was set to phase out the federal estate tax by 2010, and, as the following chart shows, it did just that as there was no federal estate tax for 2010. This chart also shows that after 2010, the federal estate tax was brought back into the tax system with a $5 million exemption and a 35 percent tax rate (Estate Tax FAQs 1).

YEAR	EXEMPTION	TOP RATE
2002	**$1 million**	**50%**
2003	**$1 million**	**49%**
2004	**$1.5 million**	**48%**
2005	**$1.5 million**	**47%**
2006	**$2 million**	**46%**
2007	**$2 million**	**45%**

2008	$2 million	45%
2009	$3.5 million	45%
2010	No Estate Tax	No Estate Tax
2011	$5 million	35%
2012	$5 million	35%
2013	$1 million	55%

(Estate Tax FAQs 1).

Following the settlement of EGTRRA, the federal estate tax exemption was set permanently at $5 million, and indexed for inflation in future years. For 2013, the exemption amount is $5.25 million. Also, the federal estate tax rate was permanently set at 40 percent (Jacobs Deborah L After 2). This gave stability to the immediate future of federal estate tax legislation.

Immediately before the beginning of 2013, there was much deliberation about the federal estate tax. During 2012, the federal estate tax exemption was set at $5.12 million with a 35 percent tax rate on anything above the $5.12 million amount. The $5.12 million was $5 million indexed for inflation (Moeller 1). This meant that decedents who passed away in 2012 were able to pass up to $5.12 million in wealth to their descendents or beneficiaries. The wealth could include assets such as cash, land, buildings, cars, etc., at their fair market value at the time of death.

b) The Debate Today

This tax has come under much scrutiny recently with the expiration of the EGTRRA of 2001. On January 1, 2013, the exemption amount was set to revert to the pre-Bush Tax Cut era of a $1 million exemption with a 55 percent tax rate, compared to the 2012 exemption amount of $5.12 million with a 35 percent tax rate. Many farming and ranching business owners in America were opposed to this reversion because often the owner of the business and the business itself are considered together, not separately, for tax purposes, and thus, the business is included in his or her gross estate at the time of death. This inclusion in the gross estate would cause a higher gross estate value and could result in more federal estate tax owed. On the other hand, proponents of the reversion argued the exemption amount should return to the pre-EGTRRA rates (or at least be lowered and accompanied by an increased tax rate) in order to prevent vast amounts of wealth from accumulating in just a few families. An example of this would be the Hilton family, who own the Hilton hotel chains. Without a federal estate tax, Richard Hilton could pass all of his wealth on to his children, one of who is Paris Hilton, a Hollywood icon. This could result in wealth never being taxed and accumulating and growing from generation to generation. Patrick Lester, who is the director of Federal Fiscal Policy at the Center for Effective Government, explains, "The idea of the estate tax is to prevent the very wealthy among us from accumulating vast fortunes that they can pass along to the next generation. The poster child for the estate tax is Paris Hilton…. That's who this is targeted at, not ordinary Americans." (Jeunesse 2).

This presents the debate of the federal estate tax. Does it affect farming and ranching business owners as they claim? Or, does it prevent the wealthy from accumulating enormous amounts of wealth? Or does it do both? Farming and ranching business owners claim this because they say they would have to sell part of their business to pay the tax. This business is how they make a living. This is in contrast to someone who does not own a business and is independently wealthy, such as a Hollywood icon. They may be able to afford the tax because they are cash-rich, compared to a business owner who may be cash-poor. The following examples show both sides of the debate. One example shows how the loss of government revenue from the estate tax has hurt communities, while the other example shows how the federal estate tax can hurt farming and ranching businesses in America.

The first example is about the loss of a state estate tax in Ohio. While up to this point the focus has been on the federal estate tax, state estate taxes are essentially the same concept but with different exemptions and tax rates. In his article entitled "Communities Find Losing Estate Tax Money Painful," Jim Kelley states that in 2010, the state of Ohio earned around $231 million in tax revenue from the state estate tax. The city of Kettering, Ohio received around $3 million in tax revenue from the state estate tax, and this comprised around 3 percent of its annual revenue (Kelley 2). When this source of funding was removed, the city was forced to make budget cuts. Kettering's City Manager explained, "…estate tax revenue has gone into every road… and building…." (Kelley 1). In this situation, the loss of the estate tax hurt the community and forced them to make spending cuts.

This example points out how a tax on the wealthy, and the resulting redistribution of wealth, can aid other people and communities.

Farming and ranching businesses are often at the center of debate for the federal estate tax issue. This is because farming and ranching are very capital intensive, which often leaves the businesses, and thus the owner, asset rich, but cash poor. Also, there has been a drastic increase in the fair market value of land. This has brought the issue to light in recent years. If the exemption had gone to $1 million, of the two million farms and ranches around the United States, 95 percent of farms and ranches would have been affected, as 98 percent of all farms and ranches are family farms (Fox; AFBF).

When an asset-rich sole proprietor dies, he/she leaves a very large gross estate. This has the potential to result in a high federal estate tax. Since the owner is cash poor, it is argued the estate would have to sell assets to pay the tax. These assets are what a business uses to generate income for the owner. The sole proprietor's estate is then, essentially, forced to sell part of the business in order to meet the federal estate tax obligations.

As an example, when a California rancher inherited a ranch from his grandfather, he was forced to pay $2 million in federal estate taxes because his taxable estate was large. The vast majority of the inheritance was tied up in 22,000 acres of land for cattle. Had the federal estate tax reverted back to the $1 million exemption with a 55 percent tax rate on January 1, 2013, the tax for the rancher's children to inherit the ranch would have been around $13 million (Jeunesse 1). Even with the new 2013 exemption, there is still likely to be a vast amount of tax on the

inheritance of the ranch. If his children cannot afford the tax, which will likely be more than the $2 million the rancher originally paid to inherit the land, part of or all of the ranch will have to be sold. This shows why ranchers and farmers are often at the center of the federal estate tax debate; it could mean selling farms or ranches that have been in the family for generations.

There is much debate about the federal estate tax. Some argue in favor of it to prevent wealth accumulating into the hands of only a few, while others argue against it because it could force the sale of profit-generating assets of farming and ranching businesses in America. Congress has permanently extended the 2012 federal estate tax exemption and indexed it for inflation with a 40 percent tax rate (Sullivan 2). Even with this extension, there are still questions about the federal estate taxes' economic effects on America, such as how long the current tax law will last and how this uncertainty will affect farmers and ranchers.

CHAPTER THREE- PROPOSED LEGISLATION

There was various proposed legislation at the end of 2012. The following chapter will explain different proposals of the estate tax legislation, as well as what was scheduled to happen at the beginning of 2013.

a) The Federal Estate Tax Law Today

Following the settlement of the federal estate tax law at the beginning of 2013, the federal estate tax exemption was set permanently at $5 million, and indexed for inflation in future years. For 2013, the exemption amount is $5.25 million. Also, the federal estate tax rate was permanently set at 40 percent (Jacobs

Deborah L After 2). This gave stability to the immediate future of federal estate tax legislation.

b) The Scheduled Change on the Federal Estate Tax

As mentioned before, the federal estate tax exemption was scheduled to revert to the previous exemption of $1 million with a 55 percent tax rate on anything above the $1 million amount. This reversion was hotly debated because it was so vastly different from the $5.12 million exemption and a 35 percent tax rate, and more families would have been affected by the federal estate tax. Some of these families may not have even thought about planning for the federal estate tax.

c) Basic Example

Before beginning with further examination as to whether or not there are adverse effects on farming and ranching businesses in America, a basic example will help to understand how the federal estate tax works.[1]

1 [1] See Figures 3.1 and 3.2 in appendix

d) Explanation of Example

Tommy John		
Cash	$ 500,000	
Investments	$ 600,000	
House and Lot	$ 250,000	
Vehicles	$ 50,000	
Farmland	$ 4,000,000	
Life Insurance Policy	$ 800,000	
Gross Estate	$ 6,200,000	
Charitable Deduction	$ (100,000)	
Taxable Estate	$ 6,100,000	
Estate Tax	$ 2,385,800	[345,800 + (40% x amount > 1,000,000)]
Less Exemption Credit	$ (2,045,800)	[($5,250,000 - $1,000,000) x 40%] + $345,800
Estate Tax Owed	$ 340,000	

This is a simple example of the decedent Tommy John. For this example, he is a single man, who died in 2013. He had made no taxable gifts in his life, and thus, has the full federal estate tax exemption of $5.25 million.

At the time of his death, Tommy had $500,000 in cash and $600,000 in investments. The house and lot that he lived on had an appraised fair market value of $250,000 on the day of his death. The two cars and one truck that he owned had an appraised fair market value of $50,000. Tommy also owned 500 acres of farmland which averaged $8,000 per acre fair market value for a total fair market value of $4,000,000. The last thing included in Tommy's estate was a life insurance policy, which he owned, and thus the $800,000 life insurance policy will be included in his estate.

All of these assets make up Tommy's gross estate, which is defined as all property owned at the time of death (Harl Neil E. 38). This brings his total gross

estate to a value of $6,200,000. The next step is to take the charitable deduction from the gross estate. In his will, Tommy left a total of $100,000 to various charities. Because he did this, the $100,000 will not be subject to federal estate tax, and thus, will lower his taxable estate by $100,000 and bring his taxable estate to $6,100,000.

The next step would be to calculate the amount of federal estate tax owed. This would be done using the above 2013 gift and federal estate tax rate schedule (Estate Planning 1). Since Tommy's estate is over $1,000,000, his tax will be $345,800 on the first $1,000,000 of his estate, plus 40 percent of the amount of the estate over the $1,000,000 level. As a result, his federal estate tax will be calculated as [40% x ($6,100,000-$1,000,000)] + $345,800, which brings his total federal estate tax to $2, 385,800.

Next, the federal estate tax credit will need to be calculated. This is done in much of the same way the federal estate tax was calculated. The total unified credit is $2,045,800. This number is calculated by taking a credit of $345,800 on the first $1,000,000 of taxable estate plus 40% of his taxable estate between $5,250,000 and $1,000,000. The federal estate tax credit for Tommy would be calculated as [40% x ($5,250,000-$1,000,000)] + $345,800, which would bring his total federal estate tax credit to $2,045,800. The amount of the federal estate tax credit is the lesser of the federal estate tax due before the credit and the maximum allowable credit of $2,045,800.

The final step is to calculate the amount of federal estate tax actually owed. This is done by taking the difference between the federal estate tax owed, which is $2,385,800, and the amount of the federal estate tax credit, which is $2,045,800.

After doing this last calculation, the amount of federal estate tax owed comes to $340,000. This amount will come from the assets of Tommy's estate.

e) Other Viewpoints on Federal estate Tax Legislation

There are many issues with federal estate tax legislation. One of these issues is the amount of uncertainty connected to the laws that are passed. The recent federal estate tax laws were made permanent when they were passed. However, permanent is more of a relative term when it comes to legislation because permanent only lasts until Congressional members vote to pass new legislation, and thus change the "permanent" laws. This can make succession planning for family businesses very difficult because there is uncertainty in what the federal estate tax laws will be in the future.

Even though the federal estate tax exemption of $5 million, indexed for inflation at $5.25 million for 2013, was set permanently at the beginning of 2013, there were different propositions made for the federal estate tax law, some of which are still talked about today. President Obama would like to see the federal estate tax law set in 2018 at an exemption amount of $3.5 million, with no index for inflation, and a 45 percent tax rate (Collins 1). This is the same proposal he made during deliberations at the end of 2012.

Other people would like to see the current legislation continued at the current rate. Iowa State University's Dr. Neil Harl[2] is one of these proponents. Harl

---

[2] J.D., University of Iowa, 1961; Ph.D in Economics, Iowa State University, 1965; Charles F. Curtiss Distinguished Professor in Agriculture at Iowa State University; Emeritus Professor of Economics at Iowa State University; Harl, Farm Estate and Business Planning, 17th edition, 2013; Harl, Agriculture Law, Matthew-Bender & Co. LexisNexis (15-volume treatise)

said, “I do believe we need a federal estate tax. The current bill we have is a fair bill and is a fair approach. It removed a lot of worries… it allows over 98 percent of decedents not to pay federal estate tax.” (Harl Neil Phone 22 July 2013). Another reason Harl points towards the current legislation being fair is it allows for a jump in basis at death. This means when an asset is passed on to the beneficiary of the decedent’s estate, the income tax basis for the asset is the fair market value on the day of the decedent’s death. Without this jump in basis and without a federal estate tax, Harl says “… 100 percent of the people in the U.S. would be affected, compared to only 1 percent with the current federal estate tax.” (Harl Neil Phone 22 July 2013).

Some believe the federal estate tax should be eliminated entirely. Members of the Family Business Estate Tax Coalition are among those supporting complete repeal of the federal estate tax (Estate Tax Reform). As noted on their website, members of the Family Business Estate Tax Coalition believe, “The cost associated with planning for and eventually paying the federal estate tax reduces business capital. All of which means less investment in business growth and job creation” (Estate Tax Reform).

Another viewpoint is to raise the federal estate tax exemption. Ken Miller,[3] partner with McGladrey LLP, would like to see the federal estate tax raised from $5 million to $10 million. “It is difficult to measure where the most appropriate place is to set the exemption amount. However, it is easy to see that in today’s environment

[3] B.A. in Accounting, University of Illinois, 1978; C.P.A., June 1978; Partner with McGladrey LLP for 29 years; Presented Continuing Education Programs with McGladrey LLP for over 30 years; Member of AICPA; Iowa Society of CPA; Licensed to practice in Iowa, Illinois, and Wisconsin

the amount of capital required to compete in today's business environment is quite significant. So I would increase the federal estate exemption from $5 million to a minimum of $10 million." (Miller 22 July 2013)

CHAPTER FOUR- ISSUES WITH LEGISLATION

This chapter will explain legislation of the federal estate tax. It will highlight the issue of the permanent federal estate tax law. Also, it will show potential effects of legislation.

a) "Permanent"

As mentioned before, President Obama would like to see the federal estate tax revert back to the 2009 law in 2018. This included a $3.5 million federal estate tax exemption, which President Obama does not want indexed for inflation, and a 45 percent tax rate on any amount above the $3.5 million exemption (Collins 1). If this were to pass, this would undo the "permanent" legislation just five years after President Obama signed it into law.

Uncertainty with "permanent" laws will make planning very difficult. Ken Miller made this point in an interview:

"Transition of business ownership usually doesn't happen over night, and the impact of ownership changes has a long-term impact on the business… Unfortunately, strategies put into place one year may be completely worthless if the tax laws change a year or two later. We say our current federal estate laws are "permanent" just because they have no short-term lapse date, but permanent is only as long as Congress does not change the rules. We need to develop a system that will allow the strategies to continue for longer periods of time." (Miller 22 July 2013).

Uncertainty can be very costly to the businesses. Planning and revamping the estate and succession planning can run thousands of dollars. If legislation changes every year or two, the estate and succession planning costs can add up very fast. Truly long-term legislation could help lessen this burden of planning on owners of farming and ranching businesses.

b) Effects of Legislation

There are positive and negative effects of federal estate tax legislation on farming and ranching businesses. One of the positive effects that federal estate tax legislation has on business owners is it forces them to consider the future, including events most people do not want to think about, such as a sudden death of an owner or partner. Pre-planning for these circumstances means the business is more likely to survive if one of the situations happens, even if it involves the sudden loss of an owner of a closely held business.

Miller said, "…proper estate planning actually improves stewardship of the family business assets by getting the next generation involved in understanding the business sooner and taking on "owning" the ownership issues sooner while the first generation is still there and active to help direct the transition issues," (Miller 22 July 2013).

However, the issue with planning for federal estate taxes is two-fold. If a person's estate is far below the federal estate tax exemption level and includes a farming and ranching business, the person may not consider succession planning because the federal estate tax will not affect their estate. With an exemption level above the estate value, owners may "over simplify" their estate plans (Bohr Steve

Estate Planning 1). They may not pay close attention to needed planning, and thus have a simple estate plan that does not properly pass the business on to the next generation. This leaves the owner in a comfort zone, believing there is no need to plan as thoroughly for transition at death. However, if the federal estate tax legislation changes right before death, and results in a federal estate tax, lack of thorough planning could have an adverse effect. Also, it may not be clear to the beneficiaries who is suppose to take over and run the business. Even if the federal estate tax will not affect one's estate, planning for federal estate tax is still important because it creates a way to deal with federal estate tax law changes and also helps families look at important non-tax issues.

At the end of 2012, with the federal estate tax set to go back to a $1 million exemption and a 55 percent tax rate, many people across the country were planning for the change. Some people were advised to sit and wait to see how Congress would finally act on the federal estate tax law. Others were advised to prepare for the exemption reverting to the $1 million exemption level, and in doing so, these people made gifts to their family members. However, many people ended up regretting these gifts because they could have kept them and still not paid estate tax on these assets because of a higher federal estate tax exemption amount in 2013 (Harl Neil Phone 22 July 2013).

When a beneficiary inherits an asset from a decedent, the beneficiary receives a new basis for income tax purposes on that asset (Harl Neil E. 26; IRC §1014). However, when a beneficiary receives an asset as a gift, the beneficiary does not receive a new income tax basis on that asset. The original income tax basis that

the donor had is carried over to the beneficiary. Thus, the beneficiary has the same basis the donor did. Because of the lack of new basis, there could be incredible income tax consequences later on if the asset is sold. Take the following example:

Assume towards the end of 2012 a father deems he has an estate that is below the current (at that time) $5.12 million exemption, but above the $1 million federal estate tax exemption, scheduled to go into effect on January 1, 2013. In an effort to eliminate federal estate tax on his estate of $2.3 million, the father gifts the son 150 acres of farmland valued at $1.5 million with an income tax basis of $100,000.

By giving this gift, the father has most likely eliminated any potential federal estate tax for his estate. However, the federal estate tax law did not go to the anticipated $1 million exemption in 2013, but changed to the $5.25 million exemption. The father is still essentially safe from federal estate taxes, but the son lost the jump in basis. Because the land was a gift and was not inherited, the son retains the $100,000 income tax basis. If the son had received the land as a result of his father's death, the son would have received a new basis of the fair market value of $1.5 million. Assume the son wants to sell the land in 5 years, and it sells for $1.3 million. The son will now have to pay capital gains tax on the difference of $1.2 million ($1.3 million - $100,000) compared to taking a capital loss of $200,000 ($1.3 million - $1.5 million) if the land had been inherited. Assuming a capital gains rate of 23.8 percent (Federal 1), this would mean the son would have to pay capital gains tax of $285,600 ($1.2 million * 40%), compared to taking a capital loss of $200,000. If this land had not been gifted and the law had changed to the $1 million exemption

with a 55 percent tax rate, the father's estate would have owed $715,000 in federal estate taxes. This was calculated as [($2,300,000-$1,000,000)*55% + $345,800].

Federal estate tax legislation has both positive and negative effects on families and their businesses. Planning for the federal estate tax can help families look at a plan for the succession of the business, but over-planning can happen due to uncertainty of future laws. Over-planning can result in consequences beyond just the federal estate tax issues.

CHAPTER FIVE- SPECIAL PROVISIONS

There are various provisions that can benefit farming and ranching businesses for federal estate tax purposes. Portability, the special use valuation, family-owned business deduction (although now repealed), and deferral estate taxes are all provisions available to use for farmers and ranchers in regards to federal estate taxes. This chapter will explain these provisions.

a) Portability

While portability is available to anyone, even if no business is owned by the decedent, it is still very important to the federal estate tax and how it affects farming and ranching businesses. Portability is the ability for the surviving spouse to use any of the decedent spouse's unused federal estate tax exemption (Jacobs Deborah L After 2; IRC §2010(c)(5)(A)). If a decedent uses $4.25 million of their federal estate tax exemption, they would still have $1 million of unused exemption left. Instead of the $1 million going to waste, the unused $1 million exemption would be added to the surviving spouse's $5.25 million for a total exemption amount of $6.25 million.

Another aspect of the legislation at the end of 2012 was that it extended the unlimited marital deduction, which allows for the first spouse to die to transfer an unlimited amount of wealth to the surviving spouse's estate tax-free, assuming the surviving spouse is a U.S. citizen (Jacobs Deborah L After 2). All of this is done without use of the federal estate tax exemption. If portability and the marital deduction are properly used, a couple can transfer up to $10.5 million in wealth to their children or other beneficiaries. This is because the marital deduction will allow for $0 in taxable estate, and thus none of the $5.25 million exemption will be used. All of the unused exemption will then be transferred to the surviving spouse.

In order to elect portability, the executor of the estate must file a federal estate tax return (Miller 22 July 2013). This must be done within nine months of death or done before the six-month extension, if the extension is elected. Lack of filing a federal estate tax return or missing deadline causes the surviving spouse to forfeit any unused exemption (Jacobs Deborah L After 2).

b) Special Use Valuation

The special use valuation is a provision specific to family-owned businesses, but is most often used in the farming and ranching business. This provision allows land in a farming business to be valued at a price comparable to the value used in the business, rather than at the fair market value selling price of the land. There are two different ways of valuing the land under the special use valuation: the cash rent capitalization method and the five factor formula method (Harl Neil E. 40; IRC §2032).

The cash rent capitalization method is the more common of the two methods. This method uses cash rent figures on tracts of comparable land from the five most recent years (Harl Neil E. 39-40; IRC §2032). The cash rent capitalization method takes into account the average cash rent, property taxes, and the effective interest rate from the Federal Land Bank District where the land is located. All of these factors are over the past five calendar years (Harl Neil E. 40-41; IRC §2032). To figure out the special use valuation of the land, take the average cash rent and subtract the property taxes. Then divide the difference between cash rent and property taxes by the effective interest rate for that particular Federal Land Bank District.

Assume the same 150 acres of land from the example in chapter five. This land had a value of $10,000 per acre. Also assume that over the last five years the average cash rent is figured to be $300 per acre, with property taxes at $35 per acre, and an effective interest rate of six percent. The formula would look like this: ($300-$35)/.06. This would bring the special use valuation of the land to $4,417 per acre. As a result, this would make the entire value of the farmland $441,667, adding far less value to the estate compared to the $1.5 million fair market value of the land. Note: the special use valuation cannot reduce an estate by more than $1,070,000 in 2013. This figure is inflation adjusted (Harl Neil E. 43; IRC §2032). There are certain criteria under which farmland must fall in order to be valued in an estate under special use valuation.

The first criteria is that the value of the farm property, whether real or personal must be at least 50 percent of the gross estate, while the second criteria is

that 25 percent of the estate must be attributed to real farm property. Both of these are figured using fair market values (Harl Neil E. 43; IRC Sec. 2032A(b)(1)(A) and (B)).

For the third criteria, it must be determined whether the decedent or a member of the decedent's family have an equity interest. This is done by performing the qualified use test (Harl Neil E. 43; IRC Sec. 2032A(b)(2)). To be seen as qualified use and thus an equity interest, the land must be used as a "farm" for "farming purposes," by the decedent or the decedent's family member at the time of death of the decedent and for five of the last eight years prior to the decedents death (Harl Neil E. 47; IRC §2032). In addition to that, a qualified heir must meet this qualified use test during the ten-year recapture period following the decedent's death. If this is not met during the recapture period, the Internal Revenue Service can order a recapture of the federal estate tax benefits (Harl Neil E. 40; IRC §2032). This prevents a family from taking advantage of the special use valuation but then foregoing the family farm operation after death.

The fourth criteria for treating land under the special use valuation requires the decedent or member of the decedent's family to have owned the farmland for five of the last eight years prior to the decedent's death and used it within the farming business (Harl Neil E. 44; IRC Sec. 2032A(b)(1)(C)). This would exclude any land bought just prior to death. In addition, the fifth criteria requires the decedent or member of the decedent's family to have materially participated in the farming business for five of the last eight years before the earlier of retirement, disability, or death (Harl Neil E. 44). The sixth and final criteria requires a qualified heir to

receive a present interest upon death of the decedent (Harl Neil E. 44; IRC §2032). In the end, if the land has been in the family farm business for at least five years and this plans to continue for the next ten years following death with little likelihood of the land being sold, special use valuation can be a provision to lower a taxable estate and thus save federal estate taxes.[4]

c) Family-Owned Business Deduction

The family-owned business deduction was repealed for deaths after 2003 (Harl Neil E. 95). This gave a deduction for federal estate taxes for those who were carrying on a family business after death of an owner. Even though it is no longer in effect, it should still be mentioned and kept in mind. Congress could bring this deduction back into the tax law. The most likely scenario where this would happen would be if the federal estate tax exemption would be lowered (McEowen 1). In the end, it is unlikely this would be brought into the tax law, but should be noted in regard to federal estate taxes.

d) Deferral of Federal Estate Taxes

Another provision given to farming and ranching business owners in regard to federal estate taxes is the ability to defer payment of federal estate taxes. Like the special use valuation provision, this provision is available to any family-owned business. However, it is most often associated and used in a farm or ranch estate

---

[4] It should also be noted that while land elected to special use valuation does decrease the value of the land and could in turn lower federal estate taxes, there are some income tax consequences. When land is valued under the special use valuation, it does not receive an income tax basis equal to the fair market value of the land (Harl Neil E. 46; IRC §2032). Instead, the income tax basis is the special use value (Harl Neil E. 55; IRC §2032). Just like with gifting, this could lead to additional capital gains tax if the land is ever sold.

situation. Estates are able to use an installment payment to pay federal estate taxes over 177 months, which is 14 years and 9 months (Harl Neil Phone 22 July 2013; IRC §6166). This is most often referred to as a 15-year installment payment option.

With this option, estates can completely defer federal estate taxes, while only paying interest, for up to five years following the death of the decedent. However, federal estate taxes can only be deferred on the part of the estate that is comprised of the farming business, and they are only eligible for this deferral if more than 35 percent of the adjusted gross estate is made up of the farm business (Harl Neil E. 134).

One of the attractions to this deferral of federal estate taxes is the low interest rate on the unpaid amount of estate taxes. For 2013, this rate is two percent on the first $1,430,000 of taxable estate ($1,000,000 adjusted for inflation) (Harl Neil E. 135). Since the rate is so low, the cost of deferral of federal estate taxes is also very low. This can actually help the business because money can be invested in the business rather than being paid in taxes for this first five years. The following table shows the potential savings with deferral of federal estate taxes (Harl Neil E. 137).

Table 16. Net savings from installment payment of federal estate tax under varying rates of return.

(Assumed Tax Bill of $ 100,000)

(1) months after death	(2) principal	(3) * interest	(4) total payment	(5) 3% return on capital	(6) 6% return on capital	(7) 8% return on capital
9	0	0	0	0	0	0
21	0	2,000	2,000	1,000	4,000	6,000
33	0	2,000	2,000	1,050	4,320	6,600
45	0	2,000	2,000	1,102	4,666	7,260
57	0	2,000	2,000	1,158	5,039	7,986
69	10,000	2,000	12,000	1,216	5,442	8,785
81	10,000	1,800	11,800	1,176	5,471	9,063
93	10,000	1,600	11,600	1,135	5,515	9,369
105	10,000	1,400	11,400	1,092	5,557	9,706
117	10,000	1,200	11,200	1,046	5,601	10,077
129	10,000	1,000	11,000	999	5,649	10,485
141	10,000	800	10,800	949	5,701	10,933
153	10,000	600	10,600	896	5,757	11,426
165	10,000	400	10,400	841	5,818	11,969
177	10,000	200	10,200	783	5,883	12,566
	100,000	19,000	138,000	14,443	74,427	132,225

*The calculations in this table do not reflect daily compounding of the 2 percent interest rate.

As the chart shows, net savings greatly increase as the return on capital increases. While generating a three percent return on capital, deferral and subsequent installment payments on federal estate taxes could save over $14,000. With a six percent return on capital, savings of over $74,000 could be generated. If a business is able to generate an eight percent return on capital over the 15 year

period, the business would generate a saving of over $132,000, which is actually more than the assumed tax bill. As the chart shows, there is the potential for economic benefit with the deferral of federal estate taxes.

However, there is the other side to the deferral and installment payment of federal estate tax provision. The business owner would need to consider the risks of the business continuing for the deferral and installment payment period. Should the business come under hard times, it could become difficult to make the continued payment of federal estate taxes.

As with the special use valuation provision, there are certain things that should be watched in order to avoid forfeiting the right to installment payments and thus forcing immediate payment of the remaining federal estate taxes. If more than 50 percent of the business is disposed of, the remaining federal estate tax becomes due (Harl Neil E. 146). Specific to a farming business, if a farm goes from being farmed by the owner to cash renting the farm by way of a lease, this is considered disposition of the farm (Harl Neil E. 147; IRC Sec. 6166 (g)(1)(A)). Thus, the remaining federal estate tax would become due.

Continuation of the business should be carefully examined when deciding whether or not to elect the deferral and installment payment of federal estate taxes. If the business is likely to continue throughout the time period of payments, then the deferral of federal estate taxes could be an economically favorable option. However, if the business will not likely continue for that 15-year period, then caution should be used when choosing to elect the deferral of federal estate taxes.

CHAPTER SIX- VARIOUS SCENARIOS

To show how planning and use of different provisions can affect the amount of federal estate tax paid, the following example will be used:

Tom and Betty Smith	
Cash	$ 350,000
Farmland	$ 6,800,000
Machinery	$ 1,500,000
Cars/Trucks	$ 40,000
Life Insurance	$ 600,000
Stocks/Bonds	$ 80,000
House	$ 200,000
Buildings	$ 500,000
Timber	$ 200,000
Grain	$ 1,480,000
Gross Estate	$ 11,750,000
Debts	$ (500,000)
Taxable Estate	$ 11,250,000 [5]

This example shows how a family farm estate could look. Assume Tom and Betty have four children, with one child wanting to farm. All of these examples will assume the current federal estate tax law of $5.25 million exemption with a 40 percent tax rate. These examples will show how various levels of planning can change the amount of estate tax owed.

a) No Planning

Tom is the first to die. Assuming Tom and Betty do no planning for their estates and did not file a federal estate tax return for Tom, Tom's estate would be one-half of the value of all the assets he and Betty own together. Without filing an estate tax return, portability cannot be elected. This assumes they hold their assets

[5] Farmland is 800 acres valued at $8500/acre; Timber is 100 acres valued at $2000/acre; Grain is 160,000 bu. corn at $6/bu. and 40,000 bu. beans at $13/bu.

in joint tenancy, where each person has an undivided interest in the property (Harl Neil 6; IRC §2040). As a result, Tom's federal estate tax calculation would be as follows:

Tom's Estate		
Cash	$	175,000
Farmland	$	3,400,000
Machinery	$	750,000
Cars/Trucks	$	20,000
Life Insurance	$	300,000
Stocks/Bonds	$	40,000
House	$	100,000
Buildings	$	250,000
Timber	$	100,000
Grain	$	740,000
Gross Estate	$	5,875,000
Debts	$	(250,000)
Marital Deduction	$	(5,625,000)
Taxable Estate	$	-
Credit Lost	$	2,045,800

Tom's estate would not owe any federal estate tax because of the unlimited marital deduction. Betty would take over all of Tom's assets tax-free, and the family farming operation would continue on with John, the child who wants to farm, taking over the business. This is assuming Betty would lease the land and machinery to John.

If a year later Betty passes away and assuming no meaningful changes in estate value, Betty's federal estate tax calculation would be as follows:

Betty's Estate	
Cash	$ 350,000
Farmland	$ 6,800,000
Machinery	$ 1,500,000
Cars/Trucks	$ 40,000
Life Insurance	$ 600,000
Stocks/Bonds	$ 80,000
House	$ 200,000
Buildings	$ 500,000
Timber	$ 200,000
Grain	$ 1,480,000
Gross Estate	$ 11,750,000
Debts	$ (500,000)
Taxable Estate	$ 11,250,000

At her death, Betty's taxable estate is much larger than Tom's because it includes all of his estate assets plus her assets. It is important to point out that very little of her estate is in highly liquid items (i.e. cash, stocks/bonds, etc.). The tax on her estate would be calculated as follows:

Taxable Estate	$ 11,250,000	
Estate Tax	$ 4,445,800	($11,250,000 - $1,000,000) * 40% + $345,800
Less: Credit	$ (2,045,800)	
Estate Tax Owed	$ 2,400,000	

As shown, Betty's estate would owe $2.4 million in federal estate tax. The problem is that Betty's estate does not have that amount available in highly liquid assets. Because of a lack of planning, Betty's children will likely have to sell illiquid assets to pay the tax. The most liquid assets (cash, stocks/bonds, grain, life insurance) add up to $2.51 million in value. This value is also before taking into account any income taxes, so there will actually be less after-tax dollars available to pay the federal estate tax. Also, the grain is likely needed in the farm operation to

pay farming debts. The choice will have to be made about what to sell next. Many of the remaining assets, specifically the timber and farmland, likely have family heritage attached to them because they have been in the family for generations, and the family will not want to sell these assets unless absolutely necessary. Selling farmland could have a negative impact on the John's farming business, as he could lose a portion of his business.

It is important to note here that a majority of these issues could have been avoided if thorough planning had been used. Specifically, Tom's unused credit would have greatly reduced the federal estate tax bill. This tax bill would have been much more manageable with limited consequences on the farming business, as shown in the next example.

b) With Portability

Portability is a key provision for maximizing wealth transfer and minimizing the federal estate taxes owed. Betty could have taken advantage of portability by thorough planning and filing a federal estate tax return at Tom's death. Tom's estate calculation would have been as follows:

Tom's Estate	
Cash	$ 175,000
Farmland	$ 3,400,000
Machinery	$ 750,000
Cars/Trucks	$ 20,000
Life Insurance	$ 300,000
Stocks/Bonds	$ 40,000
House	$ 100,000
Buildings	$ 250,000
Timber	$ 100,000
Grain	$ 740,000
Gross Estate	$ 5,875,000
Debts	$ (250,000)
Marital Deduction	$ (5,625,000)
Taxable Estate	$ -
Credit Used	$ -
Credit Transferred	$ 2,045,800

The only thing that has changed from the previous example is the unused credit has been transferred to Betty. There is still no federal estate tax due at the death of Tom.

Assuming the same passing situation for Betty as in the previous example, Betty's federal estate tax calculation would be as follows:

Betty's Estate		
Cash	$ 350,000	
Farmland	$ 6,800,000	
Machinery	$ 1,500,000	
Cars/Trucks	$ 40,000	
Life Insurance	$ 600,000	
Stocks/Bonds	$ 80,000	
House	$ 200,000	
Buildings	$ 500,000	
Timber	$ 200,000	
Grain	$ 1,480,000	
Gross Estate	$ 11,750,000	
Debts	$ (500,000)	
Taxable Estate	$ 11,250,000	
Estate Tax	$ 4,445,800	($11,250,000-$1,000,000)*40% + $345,800
Less: Credit	$ (4,091,600)	($2,045,800 + $2,045,800)
Estate Tax Owed	$ 354,200	

As shown above, this amount of federal estate tax is much more manageable to pay compared to the $2.4 million in the previous example. The most liquid assets would be able to cover this tax burden. No illiquid assets, such as farmland or timber, would need to be sold to pay the federal estate tax. John's farming business would be impacted little, if any, by easing the federal estate tax burden of Betty's estate. Taking advantage of portability alone can greatly decrease the federal estate tax burden.

c) With Special use valuation

Continuing with the same example, special use valuation can also lessen the federal estate tax burden. Assume Tom has already passed away and Betty has the same estate as in the previous example, except the land qualifies for special use valuation. The land value is now refigured under the special use valuation rules. The estate would look like the following:

Special Use Evaluation	$ 3,600,000	($300-$30)/.06=$4,500 per acre; $4,500 * 800 acres
Decrease Limitation	$ 1,070,000	
New Value of Farmland	$ 5,730,000	$6,800,000 - $1,070,000
Betty's Estate		
Cash	$ 350,000	
Farmland	$ 5,730,000	(800 acres @ $8500/ acre)
Machinery	$ 1,500,000	
Cars/Trucks	$ 40,000	
Life Insurance	$ 600,000	
Stocks/Bonds	$ 80,000	
House	$ 200,000	
Buildings	$ 500,000	
Timber	$ 200,000	(100 acres @ $2000/acre)
Grain	$ 1,480,000	(160,000 bu. Corn @ $6/ bu.; 40,000 bu. Beans @ $13/bu.)
Gross Estate	$ 10,680,000	
Debts	$ (500,000)	
Taxable Estate	$ 10,180,000	
Estate Tax	$ 4,017,800	($10,180,000-$1,000,000)*40% + $345,800
Less: Credit	$ (4,017,800)	(Lesser of $2,045,800 + $2,045,800 or estate tax)
Estate Tax Owed	$ -	

Using the special use valuation, the farmland value goes from $6.8 million to $3.6 million. This was based off of $300 rent per acre with $30 per acre property taxes and a six percent interest rate. However, as mentioned before, the special use valuation can only lessen the overall value of the estate by $1,070,000. As a result, the new farmland value is $5,730,000. Because of this, the gross estate is now $10,180,000. This lessens the federal estate tax from $4,445,800 to $4,017,800. Assuming they took advantage of portability, there would be no federal estate tax owed, and all wealth Tom and Betty accumulated throughout their lives would be passed on to their children tax-free.

One caution to take with using the special use valuation would be to figure out the chances of John continuing the family business in the future. If it is unlikely John will continue the farming business through the ten-year recapture period, then it may be more advantageous for Betty's estate to ignore the special use valuation and pay the resulting federal estate tax now, rather than potentially have recapture of tax later. If properly used, the special use valuation can be advantageous in saving federal estate taxes. However, income tax considerations should also be considered, as the new basis in the land will be the special use valuation figure. If the land were ever sold, it could potentially incur more capital gains tax to be paid.

d) Difference Between the Scenarios

No Planning		**Portability**		**Special Use Valuation**	
Gross Estate	$ 11,750,000	**Gross Estate**	$ 11,750,000	**Gross Estate**	$ 10,680,000
Debts	$ (500,000)	Debts	$ (500,000)	Debts	$ (500,000)
Taxable Estate	$ 11,250,000	**Taxable Estate**	$ 11,250,000	**Taxable Estate**	$ 10,180,000
Estate Tax	$ 4,445,800	Estate Tax	$ 4,445,800	Estate Tax	$ 4,017,800
Less: Credit	$ (2,045,800)	Less: Credit	$ (4,091,600)	Less: Credit	$ (4,017,800)
Estate Tax Owed	$ 2,400,000	**Estate Tax Owed**	$ 354,200	**Estate Tax Owed**	$ -

As these examples show, planning is essential to minimizing federal estate taxes, and thus, minimizing the impact on the family business. Planning cannot always completely eliminate federal estate tax. However, as the above example shows, it has the potential to save millions of dollars. Lack of planning and lack of knowledge of the federal estate tax laws would have cost the Smith family $2.4 million in federal estate taxes, but with thorough planning and utilization of provisions, the federal estate tax was eliminated.

CHAPTER SEVEN-SCENARIO WITH VARIOUS LAW CHANGES

The following scenarios assume Tom died under the current law with an exemption of $5.25 million with a 40 percent tax rate. All of his wealth was transferred to Betty tax-free due to the unlimited marital deduction. Therefore, none of Tom's federal estate tax credit was used and was transferred to Betty. In scenarios where the law is different from the current law, it is assumed to use the same progressive tax rate on the first $1 million of wealth. These scenarios will show how the differences in laws can potentially have an adverse effect on farming and ranching businesses in America.

a) Scenario 1: With the Current Law

As previously shown, Betty's estate would look like the following under the current tax law:

Betty's Estate	
Cash	$ 350,000
Farmland	$ 6,800,000
Machinery	$ 1,500,000
Cars/Trucks	$ 40,000
Life Insurance	$ 600,000
Stocks/Bonds	$ 80,000
House	$ 200,000
Buildings	$ 500,000
Timber	$ 200,000
Grain	$ 1,480,000
Gross Estate	$ 11,750,000
Debts	$ (500,000)
Taxable Estate	$ 11,250,000
Estate Tax	$ 4,445,800
Less: Credit	$ (4,091,600)
Estate Tax Owed	$ 354,200

With the $5.25 million exemption, the marital deduction when Tom died, and the portability provision, the federal estate tax for Betty's estate is fairly manageable to pay at her death. This $354,200 could be paid from her highly liquid assets, whether it be cash or life insurance proceeds. Because the federal estate tax could be paid from highly liquid assets, John, the farming son, would have minimal impact on his farming business, which he carried on when his father, Tom, died. There would likely not be any need to sell any vital farming assets such as farmland or machinery to pay federal estate taxes.

b) Scenario 2: $1 Million Exemption

For this example, assume a $1 million exemption, which is not indexed for inflation, and a 55 percent tax rate on anything above the $1 million exemption. There is also no portability available, so any unused federal estate tax credit is lost. This is similar to the federal estate tax law that was scheduled to go into effect on January 1, 2013. Betty's estate would look like the following:

Betty's Estate	
Cash	$ 350,000
Farmland	$ 6,800,000
Machinery	$ 1,500,000
Cars/Trucks	$ 40,000
Life Insurance	$ 600,000
Stocks/Bonds	$ 80,000
House	$ 200,000
Buildings	$ 500,000
Timber	$ 200,000
Grain	$ 1,480,000
Gross Estate	$ 11,750,000
Debts	$ (500,000)
Taxable Estate	$ 11,250,000
Estate Tax	$ 5,983,300
Less: Credit	$ (345,800)
Estate Tax Owed	$ 5,637,500

As shown above, there would be significant federal estate tax owed if Betty died under the federal estate law of a $1 million exemption with a 55 percent tax rate above the exemption. The available credit would have relatively little impact on the federal estate tax owed by Betty's estate.

In order to pay the tax, many illiquid assets would have to be sold. Many of these assets likely have family heritage. The available cash and life insurance proceeds would not even cover $1 million in federal estate tax. Grain could be sold. However, this is likely needed within the farming business to pay off any potential machinery debt, operating debt, or any other debt the business may have incurred. The timber could be sold, but this likely has strong family heritage, and if it was sold, would generate only a small amount of cash to pay the tax.

Betty's house and the farm buildings would likely be on the same piece of land. It is probable this is the center of the family heritage. Selling this would be like selling a priceless family heirloom. This leaves the last option of selling farmland.

Selling the land would likely generate the cash to pay the federal estate tax. However, selling the land would also be devastating to John's farming operation. Unless he would be in a financial position to buy all the land, it would likely move out of the family's hands. As mentioned before, farmers can be "cash poor" because of the amount of capital investment needed to run the business. If the land was sold to someone outside the family, there is a good chance John would not be able to farm it, and thus, would be put out of business.

c) Scenario 3: $3.5 Million Exemption

As previously mentioned, President Obama would like the federal estate tax to go to a $3.5 million exemption that will not be indexed for inflation, and a 45 percent tax rate on anything above the exemption amount. When compared to the $1 million exemption with a 55 percent tax rate, this law would be more advantageous. Betty's federal estate tax calculation would be as follows, assuming no portability is available:

Betty's Estate	
Cash	$ 350,000
Farmland	$ 6,800,000
Machinery	$ 1,500,000
Cars/Trucks	$ 40,000
Life Insurance	$ 600,000
Stocks/Bonds	$ 80,000
House	$ 200,000
Buildings	$ 500,000
Timber	$ 200,000
Grain	$ 1,480,000
Gross Estate	$ 11,750,000
Debts	$ (500,000)
Taxable Estate	$ 11,250,000
Estate Tax Owed	$ 4,958,300
Less: Credit	$ (1,470,800)
Estate Tax Owed	$ 3,487,500

As shown in the example, the federal estate tax owed would be considerably less than when there is a $1 million exemption and a 55 percent tax rate. However, Betty's estate would still owe nearly $3.5 million in federal estate taxes.

This could affect John's farming business. It may not bring the farming business completely to an end, but it potentially could. Liquid assets such as cash, life insurance proceeds, and stocks and bonds could be sold. This would cover around $1 million of federal estate tax (after any necessary income tax was paid), leaving around $2.5 million in federal estate tax left to be paid. Depending on John's financial position, he may be able to purchase some of the land to pay part, if not all of the federal estate tax. This would add quite a lot of debt to his farming operation, but save the business long-term. If this debt is something the business could take on, then there is a lesser chance of the business having to close due to paying federal estate taxes.

However, John might not be in a financial position to buy the land. If he has many other outstanding debts, then he may not be able to purchase the land. Without the land, it is likely he will not be able to continue the business. In the end, this law clearly gives John a better chance at surviving in the farming business than the $1 million exemption with a 55 percent federal estate tax rate did.

d) Summary of Various Laws

$1 million		**$3.5 million**		**$5.25 million**	
Estate Tax	$ 5,983,300	**Estate Tax Owed**	$ 4,958,300	**Estate Tax**	$ 4,445,800
Less: Credit	$ (345,800)	Less: Credit	$ (1,470,800)	Less: Credit	$ (4,091,600)
Estate Tax Owed	$ 5,637,500	**Estate Tax Owed**	$ 3,487,500	**Estate Tax Owed**	$ 354,200

The federal estate tax law that is in place at the time of a decedent's death has an enormous impact on the amount of federal estate taxes that will be paid. With the current law, there can be minimal impact on a moderately sized business. However, no matter where the exemption is set, there is always the possibility of affecting a farming and ranching business. If wealth were to accumulate far above the exemption, no matter where it is set, there will be an impact on the business.

As shown, the $1 million exemption level could have a devastating impact on farming and ranching business. This impact is magnified in the farming business, where there is a capital-intensive need. This can leave farmers rich in assets, but poor in cash.

A $3.5 million exemption offers a better scenario than a $1 million exemption. Less federal estate tax would be owed, and thus, there would be potentially less business impact. Depending on the business, however, there is still a chance for federal estate taxes to have a negative effect, and thus adversely effecting farming and ranching businesses. A higher exemption lessens the number and level of impact on farming and ranching businesses.

No matter what exemption is in place, there is always the potential for a farming and ranching business to be impacted. The only way for federal estate tax law to have absolutely no impact on farming and ranching businesses would be to eliminate the federal estate tax completely. However, raising the exemption helps minimize the impact on farming and ranching businesses.

CHAPTER EIGHT- CONCLUSION

There is always a chance for federal estate taxes to affect farming and ranching businesses in America. However, with thorough planning and legislation, this effect can be minimized. Without thorough planning and/or poor legislation, there is the potential for farming and ranching businesses to be negatively affected by the federal estate tax at the death of an owner.

If a person sees these farming and ranching business owners as wealthy and believes in wealth redistribution, he or she may think the owner's wealth should be taxed and redistributed in order to prevent a wide disparity in wealth and class. On the other hand, if one believes that a business owner has worked for the wealth accumulated in the business, the person might believe that the business owner has the right to pass on this earned wealth to heirs. The political viewpoint of an individual will affect whether or not they see the federal estate tax as problematic to farming and ranching businesses in America.

To answer the first research question, "Does the federal estate tax have adverse consequences on farming and ranching businesses in America?," The federal estate tax law has the potential to be adverse, but there are provisions in the law, as described, that help mitigate or eliminate the adverse consequences, as shown in the examples. There is the possibility of having harmful effects to farming and ranching businesses, but this possibility will always be there, as long as there is a federal estate tax law in place.

For families that run farming and ranching businesses, planning is very important. As mentioned before, there are various provisions for farming and

ranching businesses in America, whether it is the special use valuation or deferral of federal estate taxes on the business portion of the estate. With portability, there is also the option to maximize the use of the federal estate and gift tax unified credit. One of the ways the federal estate tax can help family businesses is by making the owners of the family business think about unforeseen circumstances, such as an owner suddenly passing away. In this instance, the federal estate tax actually helps the business long-term because when an owner goes to a lawyer or accountant for federal estate tax advice, the owner is often forced to think about what provisions need to be put into place to keep the business going on to the next generation if something were to suddenly happen to the owner. Because of this, families can get together and talk about the business objectives and transitional steps needed to pass the business on to the next generation.

Legislation is very important in determining the degree of impact. Where the legislation is right now is fair and adequate. However, there does need to be some modifications to the law in order to give this fairness and adequateness long-term consistency. This leads to the second research question, "If any reform is necessary, how should the federal estate tax law be modified?" The only way to truly prevent any farming and ranching businesses from being affected from the federal estate tax is to eliminate it completely from the tax code. This is very unlikely to happen. Raising the exemption amount would also lessen the potential for farming and ranching businesses to be affected by the federal estate tax. While this is more likely to happen when compared to eliminating the federal estate tax, it is still not likely to happen to the extent of raising it to say $10 million. Indexing the exemption amount

for inflation is good because it helps to take into account rising values and prices. Without the indexation, there will continue to be more and more farming and ranching businesses affected by the federal estate tax year after year, as that exemption amount loses its dollar for dollar value.

The biggest issue with legislation is the uncertainty from year to year. A "permanent" law is only permanent because there is no short-term deadline to it (Miller 22 July 2013). The law could be changed with the passing of new legislation, and thus, not be truly permanent. One of the best ways to solve this issue would be to pass a law that really is permanent and cannot be overturned. While this would be the best situation, it is not practical to have a truly permanent law. As time goes on, there are laws that need to be changed. This can make long-term planning very difficult, specifically estate planning. Since it is "long-term" planning, it generally does not happen in just one or two years. Rather, it happens over multiple years, even decades. There is a solution that would help with this situation.

To help with the problem of long-term uncertainty, there should be some long-term stability. Based on my research, I propose when an estate tax law is in effect, revisions should not go into effect for at least six years. This is equivalent to one term in the Senate and would help people writing wills and making estate plans, as wills should be revisited and reviewed at least every five years (Jacobs Deborah L When 1). For example, if a law passed on July 1, 2014 changing the federal estate tax exemption from the current $5.25 million with a 40 percent tax rate to $3.5 million with a 45 percent tax rate, it would not be allowed to go into effect until at least July 1, 2020.

This would allow people better stability to plan. They would know what the law would be for the next six years if they would happen to pass away during that period. It would minimize the number of times wills and estate plans need to be re-vamped because they would not need to revisit it every year or two with the changing of the law. Not only would this help with planning, but it would also save money on estate planning fees. When it came close to January 1, 2020 and the new law was about to go into effect, wills and estate plans could be revisited and updated. It is likely that in these six years, the farming and ranching business has changed and a new plan is needed.

In addition to time delay of new legislation taking effect, once a law is set in place, it should go on indefinitely until a new law is voted into the tax code. If a new law is passed, it would take six years for it to actually go into effect. This would greatly ease the burden of long-term planning.

In the end, with careful planning and proper legislation, federal estate tax could have minimal impact on farming and ranching businesses in America. If provisions for farming and ranching businesses are continued and proper time is given before laws are changed, people are better able to prepare for their estate following their passing, and thus, minimize the effect on their farming and ranching business. However, poor legislation and lack of planning will have an adverse effect on farming and ranching businesses. As a result, business owners should always be aware of changes in the estate tax laws that could potentially affect their businesses and estates.

LITERATURE CITED

“2032(a) â€” Farm Estate Plan.” *2032(a) â€” Farm Estate Plan*. Farm Estate Plan, n.d. Web. 21 Mar. 2013. <http://www.farmestateplan.com/estate_planning/2032a>.

Amato, Neil. “Succession Planning: The Challenge of What’s Next: More Firms Have Action Plans in Place, but Much Work Remains.” *Journal of Accountancy* 1 Jan. 2013: 44-47. Print.

"AFBF Priority Issues - The Voice of Agriculture - American Farm Bureau." *The Voice of Agriculture - American Farm Bureau*. N.p., n.d. Web. 7 Sept. 2013. <http://www.fb.org/index.php?action=issues.home>.

Biebl, Andy. “Simplify Your Estate Plan.” *The Progressive Farmer* Apr. 2013: 10. Print.

Bohr, Steve. “Estate Planners face common questions.” *Iowa Farmer Today* 18 May 2013: 35. Print.

Bohr, Steve. “Estate planning can be oversimplified.” *Iowa Farmer Today* 20 April 2013: 17. Print.

Bonner, Paul. “A Sea Change for Gift and Estate Planning: PFP Practitioner, Writer and Lecturer Martin Shenkman Outlines Opportunities and Caveats.” *Journal of Accountancy* 1 July 2011: 24-27. Print.

Bonner, Paul. “Estate Tax Protective Claim Procedures Detailed.” *Journal of Accountancy* 1 Jan. 2012: 63. Print.

Bonner, Paul Nevius. “Tax Cliff Averted: Congress Raises Rates on Wealthiest, Extends Many Provisions.” *Journal of Accountancy* 1 Feb. 2013: 46-49. Print.

Cohen, Karen S.. "The 10 Most Powerful Postmortem Planning Pointers for Trusts and Estates." *Journal of Accountancy* 1 May 2012: 34-36. Print.

Collins, Margaret, and Richard Rubin. "Obama Squeeze on Savings of Wealthy Muddles Estate Plans – Bloomberg." *Bloomberg – Business, Financial & Economic News, Stock Quotes*. N.p., n.d. Web. 29 July 2013. <http://www.bloomberg.com/news/2013-04-11/obama-squeeze-on-savings-of-wealthy-muddles-estate-plans.html>.

Deener, Jerome A.. "New Portability Rules: A Cure for Incomplete State Planning." *Journal of Accountancy* 1 July 2012: 48-52. Print.

"Estate Planning – 2013 Gift Tax Rates & Schedule." *Fremont Estate Planning Lawyer | Estate Planning Attorney in Fremont*. N.p., n.d. Web. 26 July 2013. <http://www.singhlawfirm.com/Fremont-Estate-Planning-Blog/2013/February/Estate-Planning-2013-Gift-Tax-Rates-Schedule.aspx>.

"Estate Tax FAQs." *Home*. N.p., 2011. Web. 17 Mar. 2013. <http://www.faireconomy.org/news/estate_tax_faqs>.

"Estate Tax Reform." *Estatetaxrelief.org*. Family Business Estate Tax Coalition, 2009. Web. 17 Mar. 2013. <http://www.estatetaxrelief.org/estate_tax_reform.html>.

"Federal Capital Gains Tax Rates, 1988-2013 | Tax Foundation." *Tax Foundation*. N.p., n.d. Web. 30 July 2013. <http://taxfoundation.org/article/federal-capital-gains-tax-rates-1988-2013>.

Fitts, James A. Rowe. "Family Business Transition Planning: Family Relationships and Values Can Make Succession of Family Businesses Even More

Challenging Than for Other Enterprises. Here Are Some Suggestions for Family Businesses That Can Make Succession Planning and Execution." *Journal of Accountancy* 1 Nov. 2011: 22. Print.

Fox News. La Jeunesse, William. Fox. 16 Nov. 2012. Television.

Grant, K 1; 4 Kent, and Com. 353; 2 Bl. Com. 181; 1 Litt. See. 304. "estate legal definition of estate. Estate synonyms by the Free Online Law Dictionary.." *Legal Dictionary*. N.p., n.d. Web. 22 Aug. 2013. <http://legal-dictionary.thefreedictionary.com/estate>.

Gangi, Martha E., Kimberly Henry, and Brian G. Raub. *IRS*. Rep. IRS, n.d. Web. 29 May 2013. <http://www.irs.gov/pub/irs-soi/06rpppgangi.pdf>.

Harl, Neil, and Roger McEowen. "Estate Planning." *Iowa State Extension*. N.p., n.d. Web. 1 Aug. 2013. <www.extension.iastate.edu/publications/pm993.pdf>.

Harl, Neil E. *Farm Estate & Business Planning*. 17th ed. Kelso: Agriculture Law, 2013. Print.

Harl, Neil. Phone interview. 22 July 2013.

Horsley, Scott. "'Paris Hilton Tax' Vs. 'Death Tax': A Lesser-Known Fiscal Debate." *NPR*. NPR, 11 Dec. 2012. Web. 23 Mar. 2013. <http://www.npr.org/blogs/itsallpolitics/2012/12/11/166989049/paris-hilton-tax-vs-death-tax-a-lesser-known-fiscal-debate>.

Huang, Chye-Ching, and Nathaniel Frentz. "Myths and Realities About The Estate Tax." *Center on Budget and Policy Priorities*. N.p., 5 Nov. 2012. Web. 17 Mar. 2013. <http://www.cbpp.org/files/estatetaxmyths.pdf>.

Internal Revenue Code.

Jacobs, Deborah L. “After The Fiscal Cliff Deal: Estate And Gift Tax Explained.” *Forbes*. Forbes Magazine, 11 Jan. 2013. Web. 23 Mar. 2013. <http://www.forbes.com/sites/deborahljacobs/2013/01/02/after-the-fiscal-cliff-deal-estate-and-gift-tax-explained/>.

Jacobs, Deborah L. "When Should You Redo Your Will? - Forbes." *Information for the World's Business Leaders - Forbes.com*. N.p., n.d. Web. 25 Aug. 2013. <http://www.forbes.com/sites/deborahljacobs/2012/08/09/when-should-you-redo-your-will/>.

Jeunesse, William La. “Ranchers, Farmers Brace for ‘death Tax’ Impact.” *Fox News*. FOX News Network, 16 Nov. 2012. Web. 17 Mar. 2013. <http://www.foxnews.com/politics/2012/11/16/ranchers-farmers-brace-for-death-tax-impact/>.

Kelley, Jill. “Communities Find Losing Estate Tax Money Painful.” *Dayton, Ohio, News and Information*. Dayton Daily News, 5 Feb. 2013. Web. 17 Mar. 2013. <http://www.daytondailynews.com/news/news/communities-find-losing-estate-tax-money-painful/nWGgP/>.

Khimm, Suzy. “The ‘Fiscal Cliff’s’ Estate Tax Fight, Explained.” *Washington Post*. N.p., 30 Dec. 2012. Web. 29 May 2013. <http://www.washingtonpost.com/blogs/wonkblog/wp/2012/12/30/the-fiscal-cliffs-estate-tax-fight-explained/>.

Lamp, Greg. “One Generation to the Next: 6 Steps to Making Succession Planning a Painless Process.” *C Magazine* Mar. – Apr. 2013: 7-10. Print.

Logan, David S. “The Economic Effects of the Estate Tax (Testimony of David S. Logan before the Pennsylvania House Finance Committee).” *Tax Foundation*. N.p., 17 Oct. 2011. Web. 29 May 2013. <http://taxfoundation.org/article/economic-effects-estate-tax-testimony-david-s-logan-pennsylvania-house-finance-committee>.

McEowen, Roger. “The Family-Owned Business Deduction and Equity Interests.” *Center for Agricultural Law and Taxation – Iowa State University*. N.p., n.d. Web. 31 July 2013. <http://www.calt.iastate.edu/family.html>.

Miller, Ken. Email interview. 22 July 2013.

Moeller, Philip. “Estate-Tax Changes Would Affect More Than the Super-Rich.” *US News RSS*. N.p., 03 Oct. 2012. Web. 29 May 2013. <http://money.usnews.com/money/blogs/the-best-life/2012/10/03/estate-tax-changes-would-affect-more-than-the-super-rich>.

Pippin, Sonja. “Income Tax Accounting for Trusts and Estates: Planning Allocations between Entities and Beneficiaries Is Even More Critical with Higher Tax Rates on the Horizon.” *Journal of Accountancy* 1 Oct. 2010: 62-67. Print.

“Potential Boost in Estate Tax Has Iowa Farmers Worried – Omaha.com.” *Omaha.com*. Associated Press, 10 Dec. 2012. Web. 17 Mar. 2013. <http://www.omaha.com/article/20121210/NEWS/712109923/1707>.

Powell, Mark E.. “The Generation-Skipping Transfer Tax: A Quick Guide: Boil Down the Complexities to Avoid Costly Errors in Your Clients’ Estate Plans.” *Journal of Accountancy* 1 Oct. 2009: 30-35. Print.

Ransome, Justin P. Satchit. “Valuation Discounts for Estate and Gift Taxes: Recent Court Decisions Offer Guidance on Interests in Closely Held Businesses.” *Journal of Accountancy* 1 July 2009: 32-36. Print.

Reichert, Charles J.. “Estate Must Reduce Its Credit For Tax On Prior Transfers.” *Journal of Accountancy* 1 Dec. 2010: 58-59. Print.

Reichert, Charles J.. “Gift Tax on QTIP Transfer Included in Gross Estate.” *Journal of Accountancy* 1 Apr. 2010: 52-53. Print.

Rider, Gary Pulliam. “Palimony Claim Is a Valid Estate Tax Deduction.” *Journal of Accountancy* 1 June 2011: 64-66. Print.

Roane, Dayna E.. “Two Estate Tax Rulings Uphold IRS Regulatory Interpretations.” *Journal of Accountancy* 1 Nov. 2011: 68-70. Print.

Robbins, Gary. “Estate Taxes: An Historical Perspective.” *The Heritage Foundation*. N.p., 16 Jan. 2004. Web. 17 Mar. 2013. <http://www.heritage.org/research/reports/2004/01/estate-taxes-an-historical-perspective>.

S. Doc. 108 (2005). Print.

Sarji, Hani. “More Estate Tax Changes Could Follow Fiscal Cliff Deal.” *Forbes*. Forbes Magazine, 06 Jan. 2013. Web. 17 Mar. 2013. <http://www.forbes.com/sites/hanisarji/2013/01/06/more-estate-tax-changes-could-follow-fiscal-cliff-deal/>.

Shenkman, Martin M.. “Estate Planning Action Steps.” *Journal of Accountancy* 1 Oct. 2011: 24. Print.

“SOI Tax Stats – Estate Tax Statistics.” *SOI Tax Stats – Estate Tax Statistics*. Internal Revenue Service, 22 Jan. 2013. Web. 17 Mar. 2013. <http://www.irs.gov/uac/SOI-Tax-Stats-Estate-Tax-Statistics>.

Sullivan, Paul. “The End of a Decade of Uncertainty Over Gift and Estate Taxes.” *The New York Times*. The New York Times, 04 Jan. 2013. Web. 17 Mar. 2013. <http://www.nytimes.com/2013/01/05/your-money/fiscal-deal-ends-decade-of-uncertainty-over-gift-and-estate-taxes.html?pagewanted=all>.

Treitz, Sabrina. "Estate Tax Deadlock Could Hit Hard On Family Farms « CBS DC." *CBS DC*. N.p., n.d. Web. 23 Aug. 2013. <http://washington.cbslocal.com/2012/12/12/estate-tax-deadlock-could-hit-hard-on-family-farms/>.

Wallace, Charles. “Farming and ranching business Owners Face Estate Tax Dilemma.” *DailyFinance.com*. N.p., 09 Feb. 2010. Web. 29 May 2013. <http://www.dailyfinance.com/2010/02/09/small-business-owners-face-estate-tax-dilemma/>.

“What is SBA’s definition of a farming and ranching business concern? | SBA.gov.” *The U.S. Farming and ranching business Administration | SBA.gov*. N.p., n.d. Web. 15 July 2013. <http://www.sba.gov/content/what-sbas-definition-small-business-concern>.

APPENDIX

Figure 3.1

Federal Estate Tax Calculation

Federal Estate Tax Calculation
Add: Fair Market Value of All Assets on Day of Death (Or Alternate Evaluation Date).
Equals: Gross Estate
Less: Deductions (Charitable, Administrative, Debts, Portability, etc.)
Add: Taxable Gifts Made During Lifetime
Equals: Taxable Estate
Multiply By Estate Tax Rate (See Chart Below)
Equals: Estate Tax
Calculate Estate Tax Credit: [($5,250,000-$1,000,000) * 40%] + $345,800 (Formula is for estates greater than $1,000,000; Credit is limited to the lesser of the amount of estate tax or $2,045,800.)
Subtract: Estate Tax Credit from Estate Tax
Equals: Estate Tax Owed

Figure 3.2[6]

2013 gift and estate tax rate schedule

Taxable Estate	Tentative Tax Equals	Plus	Of Amount Over
0 - $10,000	$0	18%	$0
$10,000 - $20,000	$1,800	20%	$10,000
$20,000 - $40,000	$3,800	22%	$20,000
$40,000 - $60,000	$8,200	24%	$40,000
$60,000 - $80,000	$13,000	26%	$60,000
$80,000 - $100,000	$18,200	28%	$80,000
$100,000 - $150,000	$23,800	30%	$100,000
$150,000 - $250,000	$38,800	32%	$150,000
$250,000 - $500,000	$70,800	34%	$250,000
$500,000 - $750,000	$155,800	37%	$500,000
$750,000 - $1,000,000	$248,300	39%	$750,000
$1,000,000 +	$345,800	40%	$1,000,000
Credit shelter amount $5,250,000	**Unified credit amount $2,045,800**		

[6] (Estate Planning)

This Study by: Taylor G. Johnson

Entitled: The Federal Estate Tax: A Comprehensive Look at the Effects on American Farming and Ranching Businesses

has been approved as meeting the thesis requirement for the Designation University Honors

12/9/13

Date

Rick Christ, Honors Thesis Advisor, Department of Accounting

12/20/13

Date

Jessica Moon, Director, University Honors Program