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Tax Minimization and Planned Generational Farm Wealth Transfer

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ABSTRACT

The agriculture industry has held a strong footprint in the economy of the United States since its inception. The strength of the U.S. economy and the changing tax code's effect on agriculture is similarly an ever-present impact on the profitability of operations. More than ever, the planning and execution of wise growth and market strategies, along with the increased importance of succession planning are paramount to keeping the family on their land and in business. As family farms continue their decades long trend of a decline in numbers, there are several potential causes of this. While wrestling with the costs of maintaining the land and equipment needed to be an agricultural producer rises exponentially, the farmer must be looking further ahead than next season's agribusiness plan. A critical element is to determine what are the best practice tools available to prepare for the eventual transition of the farm to the next generation. Will this be possible? This paper examines the effect of the Federal Estate and Gift Tax on agriculture and ways to use the current tax codes to lessen the burden of keeping the farm in the family and the family on the farm.

OBJECTIVE

Framed by an overview of the current decline in individual farm ownership, this paper focuses on the ongoing transfer of agricultural assets between generations. Taking into consideration the inevitable collision of wealth transfer and estate and gift taxes, this paper then proposes a gifting strategy as a flexible "roadmap" to avoid or minimize estate and gift taxes while ensuring continued family ownership of farm assets. The paper closes with a discussion of the future of estate and gift tax reform and analyzes options which would affect farm families.

INTRODUCTION

Since its inception, the United States has put down deep agricultural roots. The vast majority, nearly 85% of U.S. farms, are family owned and operated (USDA ERS, 2023). However, family ownership has followed a path of gradual decline over the years as corporate ownership has continued to grow. These farming operations play a vital role in the national economy, and especially in states with larger rural populations. Not only do these farming operations provide food, they provide an extraordinary number of jobs and opportunities for residents of small towns and cities. Family farming as an industry, however, is in a period of gradual contraction and consolidation as corporate and partnership ownership of farming has expanded and some families have exited farming. Table 1 shows the gradual decrease in acreage farmed as well as a decline in the overall number of farms in the U.S.

Table 1. Decline in Number of Operating U. S. Farms 2002-2022

Decrease In Number of US Farms 2002 - 2022
Source: 2022 Census of Agriculture, USDA
National Agriculture Statistics Service

All Farms		2022	2017	2012	2007	2002
Farms	Number	1,900,487	2,042,220	2,109,303	2,204,792	2,128,982
Land in Farms	Acres	880,100,848	900,217,576	914,527,657	922,095,840	938,279,056
Average Farm Size	Acres	463	441	434	418	440

Source: 2022 Census of Agriculture, Volume 1, Chapter 1, Table 1

The average acreage of individually owned farms shown above in Table 1 has remained fairly constant over the 20-year period analyzed. This analysis is based upon individually owned farms and excludes those owned by corporations, partnerships, estates and trusts. This demonstrates fewer individual farms and less acreage being farmed by individuals. Alternatively, a cursory review of the changes in non-individual farm ownership structures indicates some fertile ground for possible future research. As an example, estate and trust ownership of farms exhibits a near tripling in number since 1992, which may be evidence of estate planning and the generational transfer of farm ownership.

A complete analysis of the causes of all changes in farm ownership is beyond the scope of this paper. The authors do acknowledge and demonstrate in Figure 1 that continued growing losses from farm operations are likely one of the causes. But one of the less obvious causes of the decline in the number of farms is simply the “ageing out” of the generation of farmers who own and operate farms today. This “ageing out” phenomenon brings with it questions of who the next generation of farmers will be and what tax issues will arise within the transition to the next generation. This paper is not an all-encompassing analysis of all causes of individual farm ownership decline. There are many (e.g. stress, burnout, decrease in birth rates). This paper seeks to add to the already vast body of knowledge by demonstrating a possible planning solution to a resulting tax problem.

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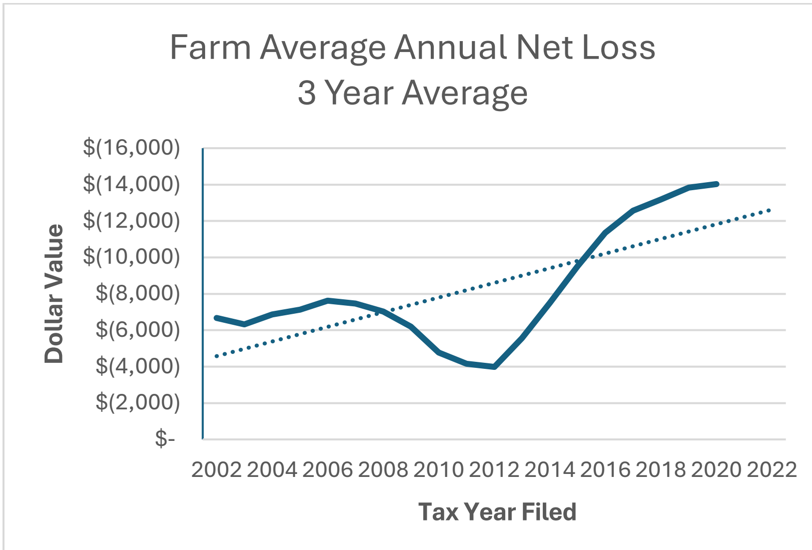
Figure 1. Farm 3 Year Average Income Less Loss



Source: Internal Revenue Service, Statistics of Income Division, Pub. 1304

One of many crucial decisions farm operators must make is in regard to generational succession planning. In other words, what is the optimal time to bring in the next generation, and when should the keys to the operation be fully transferred.

The generational succession planning process is complex, including many variables and choices to consider. However, if executed correctly, the transition can be smooth and lead to continued success for the next generation. Several tools are at the disposal of farmers to help ensure a successful transition. However, if not properly planned, this can be disastrous for the family, leading to large tax burdens or failure of the operation. The looming issue of the estate tax has been an inheritance challenge and a hot political topic for many years, with lobbyists on behalf of farmers pushing Congress to decrease or eliminate the tax altogether.

Within this paper, background information regarding the estate and gift taxes will be provided, as well as context on agricultural operations and how they are impacted by these taxes. There will be analysis of relevant tax law, referenced from the Internal Revenue Code, to find more information about the estate tax and who is subject to it.

REVIEW OF THE LITERATURE

The estate tax and the gift tax are similar taxes imposed by the Federal Government on gifts, bequests, inheritances, or other transfers of assets. The difference between these taxes is based on when they are imposed, either during a person's life or upon their death. Some states levy their own inheritance tax, either assessed against the decedent or their heir, depending on the state's law. The Federal Estate Tax is described in United States Code (U.S.C.) Title 26-Internal Revenue Code

(IRC), Section 2001, which states that "A tax is hereby imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States." The estate tax was created in 1916 to ensure that income inherited by wealthy taxpayers was taxed, since most large estates consist of unrealized (and untaxed) capital gains (Huang and Cho, 2015). The estate tax is a progressive tax, with rates ranging from 18% to 40%, depending on the amount of taxable estate, and levied after the taxpayer's death. Even at the lowest rate, the estate tax rate is high.

However, there is a credit allowed that reduces this tax, as prescribed by IRC Section 2010 here: "A credit of the applicable credit amount shall be allowed to the estate of every decedent against the tax imposed by section 2001." After 2017 and until 2025, this credit, the "Basic Exclusion Amount," is equal to $10 million multiplied by the cost-of-living adjustment from Section 1(f)(3) from the IRC and rounded to the nearest $10,000. This exclusion amount has considerably grown since the early 2000s; but if the current law is allowed to expire in 2025, the Basic Exclusion Amount would return to $5 million (plus cost-of-living adjustments). In 2025, the Basic Exclusion Amount is $13.99 million. Since the estate tax is calculated on an individual basis, the taxpayer and their spouse both have a separate Basic Exclusion Amount. This means that, in 2025, each of them has $13.99 million of Basic Exclusion to apply. This amount is also "portable" between a married couple, meaning that if one individual dies before the other, any unused amount of Basic Exclusion can be transferred to their spouse (Frequently Asked Questions on Estate Taxes, 2024).

According to the IRS website, Estate Tax Return, Form 706, is required to be filed if the gross estate of a deceased individual, plus adjusted taxable gifts, is greater than the Basic Exclusion Amount, or to elect portability (Frequently Asked Questions on Estate Taxes, 2024). If the gross estate, plus adjusted taxable gifts, is less than the Basic Exclusion Amount, no Estate Tax Return is required, none of the estate is taxable, and there is no estate tax due. According to IRC Sections 2031 and 2032, the gross estate is equal to the value of all assets owned at the time of death, or at an alternative valuation date, normally 6 months after the date of death. Additionally, per IRC Section 2035, any taxable transfers or gifts made during the 3 years before the decedent died are included in the gross estate. Next, per IRC Section 2012, taxable gifts are gifts that are given during the decedent's life that exceed the yearly exclusion for gifts. In 2025, the yearly gift exclusion amount is $19,000. The value of gifts given in excess of the yearly exemption (for the year the gift was given) is added to the gross estate. Taking this value, minus the Basic Exclusion Amount, will produce the taxable amount of estate assets. For most decedents, the value of the gross estate, plus adjusted taxable gifts, is less than the Basic Exclusion Amount, and so they are not affected by the estate tax.

Farm estates, on the other hand, are somewhat more complicated. Farming operations are extremely capital intensive. The cost of farmland, machinery, livestock, equipment, and all other investment in the farm's production capacity result in farmers often accumulating much larger estates than the average person. This in turn increases the probability of estate tax having a greater impact on farm asset inheritance. For example, the value of US farmland in 2023 averaged $4,080 per acre as published by the Economic Research Service of the United States Department of Agriculture. Large farm equipment, such as combines and tractors, cost hundreds of thousands of dollars. Newer and more technologically enhanced versions of this equipment can easily exceed one- half of a million dollars in cost. With the ever-rising price of land, machinery, and interest rates, it becomes a greater possibility that family farmers' estates may exceed the Basic Exclusion Amount and lead to them owing estate tax. In order to keep the family farm operating successfully for future generations, without amassing large sums due in estate tax, proper estate tax planning is critical. Farmers, as well as their financial advisors and accountants, must pay close attention to all aspects regarding estate taxes, current and future possibilities, to avoid significant negative impacts.

Deciding when to transfer ownership of the family farm is of utmost importance. According to a case study published in the *International Food and Agribusiness Management Review* in 2019 by Tetteh and Boehlje, their work demonstrated that the decision of when to pass the family farm over to the next generation can have an extreme impact on profitability and cash flows in following years. The future success of a family farm, and its ability to support the family, can be vastly different depending on these decisions. As published in an article by Kiella from 2019, it is estimated that 10% of US farmland will be passed down from 2019-2024. This amount of land is almost equal to the size of Montana. Kiella further emphasized the need for estate planning by sharing that an estimated 58% of Americans have not written a will (2019). When you couple a lack of planning with a larger estate, the effects of the estate tax could be catastrophic for farmers.

A key aspect of the decision to retire is the method of transfer used and the timing for the transition of assets to occur. Thorough research and creative application of several options may be required to determine the best path forward. Fortunately, farmers have a large array of instruments at their disposal when it comes to transferring their assets. These methods include gifting before death, inheritance upon death, use of separate legal entities with the transfer of ownership units (trusts, LLCs, S-Corps, C-Corps, etc.), buyouts before death, transfers of land before death with leaseback provisions, etc. All these courses of action have their advantages and disadvantages, depending on how involved the farmer wants to be going forward and how many people the farmer is passing the operation to, among other things. One major component to consider in choosing the method of transition is basis in the assets. This criteria is important to weigh when deciding between gifting before death or inheritance upon death. When gifting assets, the giftee will have a carryover tax basis from the donor, adjusted for gift taxes paid, if applicable. However, when an heir inherits assets from a decedent, they will take a basis equal to the fair market value of the asset at the time of death, or six months after. This is referred to as a "stepped-up basis," and can have a profound impact on the amount of capital gains tax the receiver has to pay when/if they sell the gifted or inherited property (Tax Policy Center, 2020).

Of course, when estate planning, it is important to consider tax law, the tax basis of owned assets, the fair market value of the assets, and the future plans for the assets. It is also equally important to remember the human side of estate planning. People have lives and they require resources to live on, therefore they must exert prudence when gifting. Put another way, a farm family could give away their entire farm during their lifetime but would still need a means to pay their bills after the gift. The following example depicts a farm couple and a plan for them to avoid estate and gift taxes by executing a strategy whereby they give away considerable wealth annually during their lifetime and pass away with a gross estate of $27.97 million. This creates a situation where no estate or gift tax would be paid under current tax law. The underlying assumption is that enough assets ($27.97 million) would be retained by the farm couple until their death in order for them to live the life they choose. Farm couples or taxpayers of any ilk with assets below these amounts ($27.97 million) and a history of no taxable gifts in their lifetime would not need to follow this strategy to avoid estate and gift taxes under the current tax laws.

In our example that follows, a farmer and his wife each pass away during 2025. They acquired considerable farmland and equipment throughout their lives and wanted their five children to inherit their estate. Upon their dates of death, the joint estate is valued at $29.4 million. Individually, they hold $14.7 million worth of property in the estate. With no estate plan in existence, their taxable estates would be $710 thousand individually or $1.42 million together. (Each are taxed on $14.7 million minus the 2025 Basic Exclusion Amount of $13.99 million) With current estate tax rates, there would be a tax of $233,500 assessed on each estate, or $467,000 of total estate tax.

If this couple had planned and implemented a properly sized gifting program during their lives, the estate tax (and gift tax) could have been avoided altogether. Since gifts below the annual exclusion amount are tax-free and do not affect the Basic Exclusion Amount, gifting is one of many tools they could have used. If, in contrast, this couple decided to give the maximum allowable gift amount to each of their five children from 2012-2021, see Table 2 below, they could have reduced the amount of the estate to below the basic exclusion amount.

Since these gifts were given more than 3 years before their death, and were not greater than the annual exclusion amount, they are considered tax-free gifts. This reduces the couple's total joint estate to $27.97 million when they pass away in 2025 ($29.4 million original estate minus the gifts given). So, each one of them would have a gross estate of $13,985 million. Since this is below the Basic [Estate] Exclusion Amount, they would not owe any estate tax.

Table 2. Gift Tax Example Illustration

Year of Gift	Gift Tax Annual Exclusion per Married Couple Source: IRS.gov	Annual Total Allowable Gifts (Exclusion amount*5 Children)
2012	$26,000	$130,000
2013	$28,000	$140,000
2014	$28,000	$140,000
2015	$28,000	$140,000
2016	$28,000	$140,000
2017	$28,000	$140,000
2018	$30,000	$150,000
2019	$30,000	$150,000
2020	$30,000	$150,000
2021	$30,000	$150,000
Total Gifts Given 2002-2022		**$1,430,000**

Source: Internal Revenue Service Form 709

In conclusion, there is no “one size fits all” estate plan which minimizes estate and gift taxes while keeping a farm in the family. Plans must deal with accompanying issues such as which assets are gifted, who will operate the farm, and ensuring equity between heirs. This is an uncomplicated example, and there are many other factors in play. However, it illustrates one possible method of estate planning. Questions, such as how the gifting is to take place (gifting of assets or gifting of ownership units such as stock or partnership shares) and questions related to ongoing operation of the farm should be resolved during the estate planning process. Proper planning can significantly reduce the amount of estate tax owed.

EPILOGUE

Campaign promises of estate tax relief leading up to the 2024 presidential election are on a “collision course” with the December 31. 2025 sunsetting of a provision in the 2017 Tax Cuts and Jobs Act (TCJA). If no action is taken this year by Congress and the president, January 2026 will bring about a reduction in the current $13.99 million Basic Exclusion amount to the pre-TCJA amount, adjusted upward for inflation. This 2026 Basic Exemption will decrease from $13.99 million to around $7 million in 2026 if no Congressional action is taken, exposing even more estates to the estate tax. If this “collision course” was not enough, a third force will also affect what type of estate tax law changes might take effect beginning in 2026. That third force is the continued budget deficit incurred by the Federal government which would be made worse should Congress decide to increase spending or decrease tax revenues elsewhere. Below are several estate tax reform options that could occur, effective January 1, 2026. All of these will potentially affect the tax burden on farmers.

Actions that could ease the tax burden on farmers.

1) Congress could eliminate the estate tax. This has been suggested before has never gained sufficient traction to become a reality. Approximately $34 billion of

revenue was generated by the estate tax in 2023. (*Estate and Gift Tax Revenue and Forecast U.S. 2034*, n.d.) Elimination of the tax would create a large budget deficit to fill.

2) Congress could lower estate tax rates across the board on all estates. This has the benefit of simplicity and fairness. Proponents of this approach point out that much of a decedent's estate will have been subject to a tax already. That is, much of the wealth in a farmer's estate at death would have already been subject to the income tax when it was earned during the farmer's lifetime.
3) Congress could provide a specific exemption for farmland and associated agricultural assets from the estate tax. The tax code is replete with targeted exemptions in support of some social or financial cause.
4) Congress could make permanent the higher Basic Exclusion (currently $13.99 million) authorized by the TCJA and allow it to continue to increase with inflation. Alternatively, Congress could just set the exclusion at $13.99 million or higher and increase it periodically in future years.

Actions that could increase the tax burden on farmers.

1) Congress could actually increase the estate tax rate across the board. The maximum estate tax rate today is 40%, but the rate has been as high as 60% as recently as 2001. (*Forms and Publications: Estate and Gift Tax*, n.d.) As unpopular as an estate tax increase may seem to farmers and others with large estates, it could be a more palatable alternative to Congress when compared to increasing income taxes to all voting taxpayers.
2) Congress could decrease even further the Basic Exemption, which is currently $13.99 million, but declines to around $7 million in 2026. Depending on the size of the exemption reduction and the size of the estate, this could trigger a significant estate tax bill for numerous estates of decedents with modest wealth upon death. As a point of reference, the exemption has not always been this high. As recently as 2003, the exclusion was only $1 million. ((*Forms and Publications: Estate and Gift Tax*, n.d.)
3) Congress could remove from tax law, the provision which allows recipients of property inherited from an estate to take a stepped up (to fair market value) basis on the property and require the recipients to take a carryover basis from the decedent. This would not increase estate taxes on the estate, but would, in many situations, increase income tax, (in many cases capital gains tax), on the recipients when they eventually sell the inherited property.

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