TEN ESTATE PLANNING CONSIDERATIONS FOR WISCONSIN FARMERS[1]

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Introduction

Estate planning for farmers is unique. Farmers often have an emotional commitment and attachment to their farms and land that is often not evident in other family closely-held businesses. Farm families have often lived on the same farmland for generations and, although cliche, it is true that most farmers still look at farming as a way of life, not just a business.

Of course, farming in Wisconsin has changed dramatically in the last three or four decades. California has replaced Wisconsin as the largest milk producing state in the country, although Wisconsin's economy remains largely dependent on dairy and agricultural production. The number of farms in Wisconsin has decreased dramatically from approximately 174,000 farms in 1950 to 93,000 farms in 1980. By 1991, the number of farms in Wisconsin decreased to about 79,000 where it has since remained level. Correspondingly, the size of farms has increased from an average of 136 acres per farm in 1950 to an average of 213 acres per farm in 1997. The average acreage per farm is somewhat skewed lower, however, by the popularity of small hobby farms in recent years. Approximately 32,400 farms, about 41% of all farms, had gross agricultural sales of $10,000 or less in 1997. Farms with annual gross sales of $100,000 or more, approximately 19,200 farms, accounted for 54% of the total land in farm use, but comprise only 24% of the total number of farms in Wisconsin.

Ten Estate Planning Issues for Famers

As the size of farms increase, the needs of farm families for appropriate tax and estate planning become critical. In Wisconsin, farmers can benefit from a variety of advantageous state laws. The following are ten of the most important estate planning issues which should be reviewed with Wisconsin farm clients.

1. Succession Plan

Probably the most important decision facing farmers today is whether or not a child will continue to operate the farm. Parents can no longer assume that one or more of the children will continue farming, particularly as more farm children desire suburban lifestyles. As the statistics above and the evidence of thousands of vacant barns along Wisconsin roadways reveal, many farmers are being forced to auction their machinery and cattle, consolidate farm buildings, and sell the farmland because their children are no longer interested in farming. For those clients who are fortunate to have a child interested

[1] We cannot guarantee that this information is consistent with current law. Please contact Willms, S.C. for current information on this topic.

in continuing the farm operation, the integration of one or more children into the ownership and management of the farm can be a very difficult task, even in the most harmonious families. There are a number of potential conflicts that may exist: (a) parents may be unwilling to give up management and control to children; (b) the capability for the farm to produce enough income to support two families; (c) how the child will begin to purchase and own farm assets; (d) the desires of the child's spouse regarding farm ownership and control issues; and (e) differing management styles and modernization concerns.

For generations, children have been assuming ownership and management of farm operations by oral "understandings," which can be the source for many disagreements. With the large capital investments of most modern farms, a formal agreement between parents and children should be established setting out the contributions of child and parents and, to some degree, the expectations of each party. In conjunction, a buy-sell agreement may be required to insure that the farm will not be literally cut in half if one of the parties dies, a divorce of the child occurs, or the child suddenly decides he or she does not want to take over the farm operation. Because the liquidity of farm parents and children is often lacking, the life insurance needs of each party should be reviewed to fund the buy-sell agreement. The succession plan should also recognize the children who will not be involved in farming to insure that all children are treated according to the client's wishes.

2. Farm Operating Entity

Farmers have traditionally operated farms as sole proprietors or general partnerships. Although farmers have often felt uncomfortable with formal business entities and may feel that added record keeping requirements are additional burdens, the use of corporations or Limited Liability Companies (LLC's) may provide substantial benefits to modern farm operations. Advantages of corporations or LLC's as the owner of the farm operation include: (a) limits the personal financial liability of the owner to assets held by the corporation or LLC; (b) provides an ongoing entity to exist at the death of parents; (c) provides more retirement planning opportunities; (d) facilitates gifts of ownership to children (parents can gift shares or membership units instead of undivided interests in real estate, machinery and cattle); (e) allows parents to retain control over all farming operations even after gifts are made (by giving non-voting stock or membership units); and (f) creates the possibility of discounting of farm assets for federal estate tax valuation purposes. Of course, the corporate or LLC entity must be respected and the required formalities observed by the officers and the shareholders or the members.

3. Planning for Disability

Farming is a very dangerous occupation. For this reason, life and disability insurance can be an important component of a farmer's estate plan. It is also crucial that farmers have made arrangements regarding the operation and management of the farm during a period of incapacitation. For this reason, farm clients should be strongly encouraged to execute a durable financial power of attorney and power of attorney for health care to avoid court

imposed guardianships and potential limitations on the ability of families to operate the farms without court restrictions. Too many planners ignore this most basic of requirements.

4. Income Tax Implications of Farmland Leases

The regulations under I.R.C. §1402 provide that farm rental income is not taxable as self-employment income unless the lease contemplates the owner's "material participation" in the production or management of production and such material participation actually occurs. "Material participation" is generally defined as paying for at least half of the cost of producing the crop, consulting with the tenant regarding crop production, taking an important part in making management decisions, which substantially contribute to the success of the enterprise, working 100 hours or more over a period of five weeks in activities connected with crop production, or any activities that taken together show a significant and material involvement in the production of the crops. If rental income is treated as self-employment income, the retired farmer may be required to pay self-employment tax and his or her social security benefits may be reduced if the farmer is under age 70 and certain income limits are exceeded.

Because many retired farmers rent their remaining farmland as a source of retirement income, the tax aspects of such rentals are important. For retired farmers renting farmland to neighbors, the issue is less important because it is unlikely the lessor will be involved in any participation, much less material participation, under the lease. The most common instance involving material participation involves the lease of farmland by farm parents to a successor child who is continuing the farm operation but has not yet begun to purchase the real estate. The parents may unknowingly expose themselves to self-employment tax or the potential loss of Social Security benefits by assisting their child with farm management issues and crop production issues related to the leased real estate. If self-employment tax is to be avoided, farmers will want to avoid crop share rent leases where landlord and tenant share in the cost of production and profits and, alternatively, utilize cash rent leases that involves fixed cash payments to the landlord with no participation by landlord in crop production issues.

5. "Double step-up" in Capital Gains Tax Basis

On January 1, 1986, Wisconsin's Marital Property Act became effective, which essentially changed Wisconsin from a common law property state to a community property state. Property owned by a married couple prior to that date is not necessarily classified as marital property. Likewise, property owned prior to marriage or received after marriage by gift or inheritance may not be treated as marital property. However, Wisconsin's Marital Property Act allows married couples to reclassify all assets titled in either spouses name as the marital property of both spouses.

Why is marital property important for capital gains tax purposes? Under the Internal Revenue Code, the basis of property received from a deceased person receives an adjustment in basis equal to the property's fair market value at the date of death (called a

"step-up" if the value of the asset has increased from the date of acquisition to the date of death). When a married person who is a resident of a common law state dies, assets titled in the name of the decedent will receive a new basis, but the basis of the property belonging to the surviving spouse is not adjusted. Further, the basis of property owned jointly between spouses only receives a step-up in basis equal to one-half of the fair market value of the asset on the date of death of the decedent. By comparison, in community property states like Wisconsin, all community property receives a full adjustment equal to the value of the property on the date of death of either spouse. Furthermore, Wisconsin statutes also provide this same "double step-up" result for state tax purposes. Since farming is such a capital intensive industry and often involves the capital appreciation of real estate and other assets, the ability to sell assets at the death of either spouse with an adjusted tax basis is a substantial benefit.

6. Utilizing Spousal Estates

Under the Internal Revenue Code, every individual is entitled to an "Applicable Unified Credit Amount", which can shelter a specified amount of assets from federal transfer taxes. This credit can shelter $625,000 of assets in 1998 but is scheduled to increase to $1,000,000 of assets for persons dying in 2006 and beyond. If a married couple utilizes both spouses' unified credits, the amount protected from federal transfer taxes can be effectively doubled. For example, assume a married couple has a combined net worth of $1.25 million. Assume, further, that the assets are jointly held in both spouse's names. If wife dies first, then the assets held in husband's name will not be available to fund wife's unified credit. Furthermore, the joint assets will pass outright to husband by right of survivorship. As a result, the wife's unified credit will not be used. Instead, all of the assets will be includable in husband's estate for federal estate tax purposes at his death. In comparison, if the couple lived in Wisconsin and had executed a marital property agreement that classifies all of their assets as marital property, then one-half (1/2) of the assets held in husband's name would be includable in wife's estate for federal estate tax purposes. Therefore, the wife's unified credit could be fully utilized.

7. Special Use Valuations for Farmland Under Internal Revenue Code §2032A

The provisions of §2032A of the Internal Revenue Code (IRC) provide a method for reducing federal estate tax valuations of real estate used in farming or other closely-held businesses up to, but not by more than, $750,000. To qualify, fifty percent (50%) or more of the adjusted value of the decedent's gross estate must consist of the adjusted value of real and personal property used in the farm or business, and 25% or more of the adjusted value of the decedent's gross estate must consist of the adjusted value of real property used in farming or the business. The same minimum percentages must actually pass to or be acquired by a "qualified heir." A qualified heir is a member of the decedent's family, which includes the decedent's ancestors, the decedent's spouse, the decedent's lineal descendants, the decedent's siblings, and the spouses of lineal descendants. "Material participation" is required to provide the benefit of the special use valuation to decedents and heirs actually involved in the farming or the business activities. First, the decedent or a

member of the decedent's family must have "materially participated" in the farming operation for at least five or more years during the eight year period ending on the earlier of the date of retirement, disability, or death, provided that retirement or disability continue to the date of death. Second, to avoid post-death recapture of tax benefits, the qualified heir or a member of the qualified heir's family must materially participate in the farming operation for at least five of the eight years following the decedent's death.

Although Section 2032A does not itself define "material participation," the IRS has issued regulations for §2032A setting forth activities that are considered in determining whether the requirement of material participation have been met. These activities include physical work, participation in management decisions, regular advice and consultation on the operation of the business, regular inspection of production activities, advancement of funds for the operation, financing a substantial portion of operating expenses, and maintenance of a residence on the premises. It appears that the first three factors are the principal elements the IRS will review for compliance. The qualified heir is subject to recapture of the estate tax, with interest, for a period of ten years after the death of the decedent if any of the following events occur, among others: (a) sale or transfer of the real property by the qualified heir to someone other than a member of the qualified heir's family; (b) termination of a qualified use; or (c) failure to satisfy the material participation requirements. All of the qualified heirs who receive qualified real property from the estate of the decedent, even through purchase from the estate, must sign a consent agreement accepting personal liability for the additional estate tax that may occur upon a recapture event.

8. The Family Owned Business Deduction under Internal Revenue Code §2057

The recently enacted Family Owned Business Deduction (FOBD) provides a significant estate planning opportunity for closely-held businesses and family farms. The special use valuation rules of §2032A, on which the FOBD is modeled, apply only to real estate, while the new FOBD legislation applies to all assets owned by farmers or other closely-held businesses, with some exceptions. If the deduction applies, the estate tax liability is calculated as if the estate were allowed a maximum family-owned business deduction of $675,000 and a unified credit exemption equivalent of $625,000 regardless of the year in which the individual dies. Thus, a farmer's estate which qualifies for the deduction will be able to transfer a total of $1.3 million of farm property free of tax.

To qualify for the FOBD, the value of the qualified family-owned business interests must exceed 50% of the adjusted gross estate (which is essentially defined as assets less deductions) of the decedent, as determined through a rather complicated formula. If more than one family owns a farm or entity operating a farm, §2057 requires at least 70% of the entity to be owned by members of two families (with at least 30% by the decedent or the decedent's family), or 90% of the entity owned by members of three families (again, decedent or decedent's family must own at least 30% of the farm or entity). Under §2057, several categories of assets are considered passive assets are therefore not included in the value of a qualified business, including "rents". Because many farms and small businesses

are structured in multiple entity form with the real estate retained in individual ownership and the operating assets held in another entity, the exclusion of "rents" is important in determining whether farm assets will qualify for the FOBD and must be reviewed carefully on a case by case basis.

Section 2057 requires that the qualified family-owned business interest must actually pass to or be acquired by a "qualified heir". Here, a qualified heir is defined as: (a) a member of the decedent's family, or (b) any individual who has been actively employed by the business for at least ten years prior the date of the decedent's death. Similar to §2032A, "material participation" is significant both prior to the death of the decedent and for the heirs to be eligible for the FOBD. As under §2032A, the decedent or a member of the decedent's family must have materially participated in the trade or business for at least five of the eight years immediately preceding the earlier of the decedent's retirement, disability or death. To avoid post-death recapture of tax benefits, the qualified heir must materially participate in the farming operation for at least five of the eight years following the decedent's death. While §2057 does not define material participation, since the provision is identical to §2032A, it is presumed that the same definitions will apply here. Finally, all of the qualified heirs who receive qualified FOBD interests from the estate of the decedent must sign a consent agreement accepting personal liability for the additional estate tax which may occur upon a recapture event occurring within ten years of the decedent's death and before the qualified heir's death.

9. Installment Payments of Federal Estate Tax Under Internal Revenue Code § 6166

Section 6166 provides for installment payment of federal estate tax for up to nearly 15 years after the death of the decedent where the estate contains a qualifying interest in a closely-held business, including farms. An executor may elect to pay part or all of the estate tax in not more than ten equal installments beginning five year after the death of the U.S. citizen or resident if the closely-held business is valued at more than 35% of the adjusted gross estate. The statute also provides a special 2% interest rate on approximately the first $1 million of deferred unpaid estate tax. Farm residences and related improvements receive special consideration for purposes of determining whether an estate meets the 35% test of §6166. The interest in a closely-held business "which is in the business of farming" includes any interest in residential buildings and related improvements on the farm that are occupied on a regular basis by the owner or lessee of the farm, or by their employees for purposes of operating or maintaining the farm. Therefore, even though not normally valued as part of a business, farm houses and other structures are taken into account in determining whether the value of the interest in the closely-held business by the decedent meets the 35% test.

10. Transferring Assets at Death: Avoiding Probate

Because farms are capital intensive, require a large amount of assets to operate, and involve an ongoing business avoiding the potential expense and delays of probate may be a concern for many clients. Probate is very simple to avoid in Wisconsin through the use of

"living" revocable trusts and, for married couples, through marital property agreements. The Wisconsin Marital Property Act provides that married persons may agree that upon the death of either spouse, either or both spouse's property, including any after-acquired property, passes without probate to a designated person, trust, or other entity. As a result, a marital property agreement that directs how a married person's assets are to be distributed can protect those assets from probate. Perhaps the most effective way to use this technique (sometimes called a "Washington Will" provisions because a more limited version of the concept originated in the State of Washington) is to direct that such assets be transferred to a living trust upon death. Wisconsin is the only state in the nation which permits a living trust to be funded after the death of the Grantor while still avoiding probate.

Conclusion

Even with significant changes in Wisconsin agricultural landscape over the last three or four decades, agriculture is the primary industry which still makes Wisconsin "America's Dairyland". As the size and investment capital in farming increases, tax and estate planning is an essential component in the success of the modern Wisconsin farmer.