A **Strategy Spotlight**
for Individuals

Estate Planning for Farmers

The business of farming shares many estate planning characteristics with other types of businesses, including questions of how to transfer the business efficiently, pay estate taxes, and plan for the owner's retirement. Due to the nature of the farming business, there tends to be more illiquid assets than one might find in other types of businesses. In fact, the largest asset of a farmer, in many cases, is their land. There is generally a ready market for land, but many farmers do not want to break up their holdings and sell it in pieces.

Assuming that the goal is to transfer the farm business as a whole with land included, liquidity is needed to pay estate taxes due at death. In general, federal estate taxes are due nine months after this date. This could mean the sale of assets fairly quickly to raise the money to pay any taxes due. A possible solution for this estate tax liability is the purchase of permanent life insurance. The death benefit may provide the needed liquidity without selling assets. Also, as a farmer, there are a few options in the Internal Revenue Code (IRC) that can help give the estate a break on taxes. Let's look at two.

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Length of Time to Pay

IRC § 6166 is commonly known as the long-term payout of estate taxes. This means that you can pay taxes over a longer timeframe instead of owing all federal estate taxes nine months after the date of death. Utilizing this method gives the executor of the estate 10 years to pay the taxes due, starting five years after the death of the individual. The amount that can be stretched in this manner is based on the percentage of the estate that represents the business. If the majority of the estate is the farm, the bulk of taxes due could be stretched.

While the government does charge interest, historically the Internal Revenue Service (IRS) interest rates have been equal to or lower than the current market rates. This offers a unique alternative for a farm business where at the death of the owner, the assets would have to be sold or a loan taken to pay taxes due. In order to be able to use this long-term payout method, the deceased person must have been actively involved in the business and the business must be over 35% of the estate. An important qualifying factor is that once the farm is passed at death, it still needs to be operated as a farm in order to utilize this strategy. If the family member who takes control does not continue to run the farm as a farm, the taxes may come due immediately.

While this may sound attractive in theory, and is for the right business and right heirs, there are nuances that are not covered here including the possibility that the IRS may require the estate to purchase a bond to ensure the future payment of the estate tax liability, so it is important to talk with your legal and tax advisors about your personal situation.

Valuation of the Farm Land

While assets are generally valued at death at their highest and best use, IRC § 2032A provides a special valuation rule for land that is actively being farmed. The special rule was intended to help reduce forced sales of land to pay federal estate taxes by allowing the land to be valued based on its farming capability rather than its development value.

While this special valuation rule may be very beneficial, there are limitations and important considerations. The special valuation rule cannot reduce the value of the estate by more than $1,100,000 (2016). This amount is indexed based upon annual cost of living factors. The most significant consideration is that if the land is sold or otherwise transferred to a non-family member within 10 years, or the land is used for something other than farming during that 10 year timeframe, all taxes must be recomputed based upon the original highest and best use value. The qualified heir who receives the property from the decedent must sign an agreement to be personally liable for the additional tax. It is due and payable within six months after the date of sale or cessation of personal use.

Is Life Insurance a Better Option?

While these two sections of the IRC may be used to help provide additional time to pay taxes and a more favorable valuation, not everyone wants to have a loan outstanding, or otherwise be subject to the IRS for so many years after the decedent's death. An alternative option is the purchase of permanent life insurance to provide liquidity sufficient to cover the insured's estate tax liability at the time of death. The insurance death proceeds will help the estate to avoid the necessity of entering into a repayment agreement with the IRS or requiring the decedent's heirs to be bound to the land without the flexibility to choose an option other than farming, if required by the heir's personal circumstances.

Life insurance can also help with other estate planning needs, such as meeting the family income needs of a surviving spouse, or providing an alternative inheritance for the Insured's children who are not in the family farm business. This provides the flexibility to transfer the farm to the children who are actively involved in the farming operations.

There are many benefits to owning permanent life insurance that may make it an attractive option for a business owner. In addition to helping to protect against the financial loss that may result from the death of the insured, one particularly attractive benefit of permanent life insurance is the ability to access the life insurance policy cash value[1] to assist with the business's short-term cash flow needs.

Talk to your personal tax and legal advisor today to see if these strategies might make sense for your individual situation. Make sure you know what estate planning documents need to be in place, keeping them current in order to help make the process of transferring assets at death as smooth as possible.

[1] Access to cash values through borrowing or partial surrenders will reduce the policy's cash value and death benefit, increase the chance the policy will lapse, and may result in a tax liability if the policy terminates before the death of the insured.

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