

Farmland

IN PERSPECTIVE

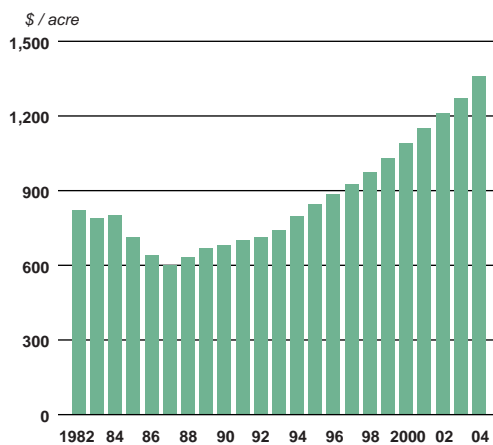
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Farm Real Estate Values Continue Strong Upward Trend

Farm real estate values, a measurement of the value of all land and buildings on farms, averaged \$1,360 per acre as of January 1, 2004, up 7.1% from 2003. This is the largest percentage increase since 1994, when farm real estate values rose 8.0% from the previous year. The \$90 per acre increase is the largest dollar increase since 1980, when values climbed \$109 per acre above the 1979 value. The increase in farm real estate values continued an upward trend that began in 1987.

U.S. Average Farm Real Estate Value Dollars per Acre, 1982-2004



Source: USDA - NASS, August 2004

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Estate Planning for Absentee Farmland Owners

By Lawrence W. Frank

Farmland ownership provides many benefits including investment diversification, economic stability in regards to valuation, and a reasonable rate of return on real investment. The associated investment risk may be less than for other investments. Farmland ownership can pose estate planning issues, however. Among these is the timing of farmland sales.

In general, a good estate plan accomplishes the goals and objectives of the farmland owner. These goals generally include:

- Transfer of the farmland (asset) to the intended beneficiaries in a cost-efficient manner
- Peace of mind from knowing this goal has been accomplished
- The hope that beneficiaries will be happy and non-litigious following the owner's death.

Accomplishing this plan requires the consideration of several factors including taxes, business continuation, and the inter-relationships of the beneficiaries. The estate planner should be made aware of these factors while assisting you with your overall estate planning strategies.

Family Considerations

One issue may be whether or not to sell the land before you die since it is easier to divide cash than land. Several factors enter into this decision. In most estate plans, fee title to the farmland will go to a group of individuals, normally the children. This transfer of title results in tenancy-in-common ownership.

Under state law, any one of the owners of the real estate may commence a legal proceeding to partition the real estate if they have differing ideas, needs or goals. This partition action results in a court-ordered sale of the land and the ultimate distribution of the net sale proceeds among the tenant-in-common owners. However, this type of sale can sometimes result in a less than market value sale of the land when the inability of family members to get along creates a forced situation.

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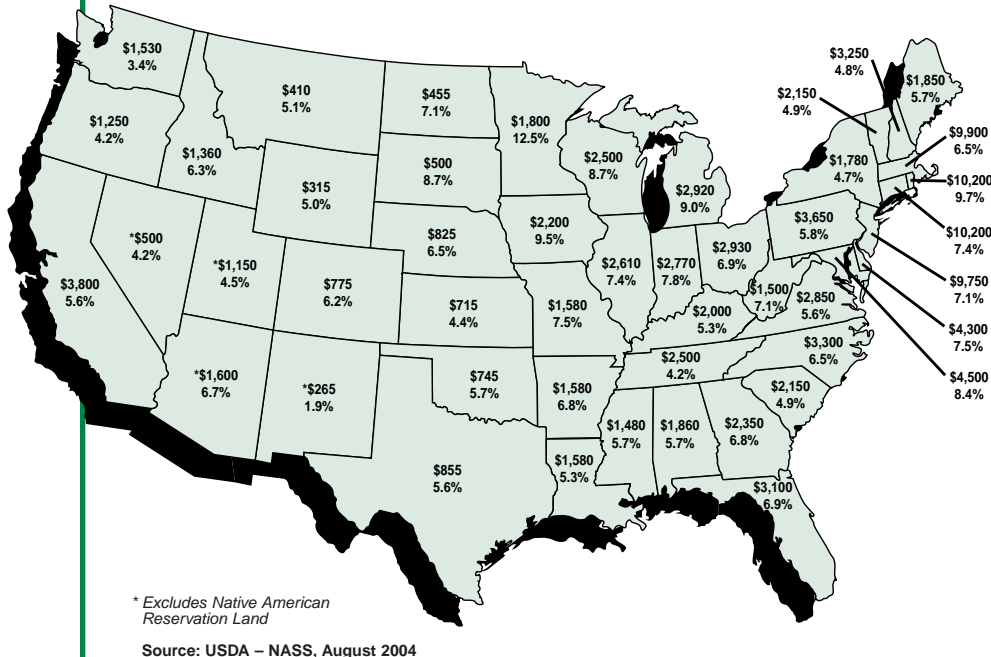
2004 Farm Real Estate Value by State

Dollars per Acre
& Percent Change
from 2003

Per acre value of farmland

USDA average as of January 1, 2004 (top number)
Percent change from January 1, 2003 (bottom number)

U.S. Average – Dollar/Acre: \$1,360 • Percent change from 2003: +7.1%



When these events occur, the family generally is divided and unable in the future to overcome the emotional scars resulting from the procedures to sell the land. Yet, even without legal proceedings, oftentimes the sale of farmland by tenant-in-common owners results in these persons not being friendly to each other in the future.

Should the landowner anticipate family feuding following the land transfer postmortem or between living beneficiaries, then the landowner should seriously consider a sale of the land prior to making an irrevocable transfer of the land. In other words, the sale of the land could preserve family harmony even though it may cost additional money due to income tax.

Revocable Living Trust

A revocable living trust is often used for the purpose of avoiding probate proceedings on the death of the owner. It is especially useful for the purpose of avoiding ancillary probate proceedings. These proceedings are required if the owner's residence is different from the state in which the land is located. For example, a Missouri resident may own land in Minnesota and under present law it would require an ancillary probate proceeding to determine the ownership of the land in Minnesota upon the owner's death. Accordingly, transferring the title to a revocable living trust avoids all probate proceedings in the State of Minnesota. Although this does not remove the value of the asset from the decedent's estate, it does considerably reduce the expenses associated with the transfer of title.

The revocable living trust is a contract between the owner and the trustee, which contract may be changed, modified and amended at any time prior to the death of the owner. Accordingly, these documents provide for the continued management of the property by the trustee who is subject to a high standard of care while still enabling the owner to control the method and disposition of the farmland following death.

Census of Agriculture 2002 Highlights

- From 1997 to 2002, the estimated market value of land and buildings on the Nation's farms rose 24%. The average value per farm increased by more than \$100,000 to reach an average of \$537,833 in 2002. The average value of land and buildings per acre increased more than \$200 to \$1,213 per acre in 2002.
- The average age of principal farm or ranch operators was 55.3-years-old in 2002 compared to 54-years-old in 1997. The average age of second operators at 49.4-years-old and third operators at 41.9-years-old.
- 90% of farms are operated by an individual or family.
- The number of corporate farms declined by 18.4% from 1997 to 2002. This reverses a trend begun in 1974.
- The top five states in value of agricultural products sold are California (\$25.7 billion), Texas (\$14.1 billion), Iowa (\$12.3 billion), Nebraska (\$9.7 billion) and Kansas (\$8.7 billion).
- Direct sales to consumers increased 37% from 1997, totaling \$812.2 million in 2002.
- The value of organically produced commodities reached \$392.8 million in 2002.

Estate Taxes

Under current estate tax laws, Section 1014 provides that if you die owning farmland, there is a full step-up in basis equal to the fair market value of the land on the date of death or the fair market value six months thereafter if election for this alternate valuation date can be made.

For landowners who want to pay no income tax on the sale of land, their estate planning documents could provide that this land must be sold following their death and the net proceeds (cash) can then be distributed in accordance with their intent. This approach is very effective in cases where the owners have reason to know that the beneficiaries may not get along with each other in the operation, management or future sale of the land.

Charitable Gifts

Other considerations exist regarding the sale of land before you die. Oftentimes, the landowner may want to make a charitable gift. Recently, a client requested information on how to create income tax deductions, increase cash flow, and minimize transfer taxes (federal estate tax and state estate tax).

After reviewing the matter, the client decided to transfer the land to a charitable tax-exempt organization. This produced a charitable deduction for income-tax purposes.

The land transfer could be done in two methods. The first method was to transfer title to the organization and retain a life estate to the owner of the land. The second method was to establish a charitable remainder trust, transfer title to the charitable remainder trust, and then retain a stream of income from the trust asset investment. Both methods resulted in an income tax deduction.

In this case, the client transferred 240 acres to the charity by deeding it and retaining a life estate resulting in an income tax charitable deduction just in excess of \$400,000.00. This charitable deduction enabled the client to reduce actual taxable income by an amount equal to 50% of their adjusted gross income, thus increasing annual cash flow while retaining the same amount of income. This procedure works well even though

the landowners are married since retention of income from a charitable remainder trust or the retention of joint life estates are possible, thus enabling both of the owners to retain income for their joint lifetimes.

Tax-Deferred Exchange

The tax-deferred exchange of land using Section 1031 of the Internal Revenue Code offers several opportunities in the estate planning process. Examples could include beneficiaries of the client who have moved from the area and established a livelihood in other areas of the United States who have a strong need for additional real estate in their investment base.

Accordingly, the client could sell the farmland owned by them and have the net proceeds from the sale reinvested to purchase land located closer to the beneficiary. This enables the beneficiary to use the land while paying a reasonable amount of rent for its use. Like-kind exchanges also allow other types of investment property to be exchanged for land, such as apartment buildings, duplexes, strip malls or other commercial structures.

The landowner redrafts his estate planning documents and devises that particular real estate to that beneficiary. Other beneficiaries would receive other land and/or assets of substantial equal value.

Freezing Asset Value

Some landowners look at utilizing in their estate plan certain techniques that freeze the increased asset value for estate tax purposes. Usually, assets that will probably inflate in value are good assets to target when using this technique.

A simple vehicle is a long-term Contract for Deed sale of the land. For example, the installment sale of land for \$2,000.00 an acre in 1995 would have a discounted value on death to approximately \$1,600.00 per acre. Another vehicle generally used is a legally enforceable option to buy, exercisable within a reasonable time in the future. These estate planning strategies try to achieve an asset valuation in the end which is less than the fair market value of the actual asset.

Discount Factors

Other strategies are used for the purpose of deploying discount factors in estate planning. A simple example is a gift of an undivided interest in real estate. An undivided one-tenth interest in a 320 acre farm worth \$1 million is worth less than \$100,000.00. If you were to sell a one-tenth interest in a commercially reasonable manner, you might get \$70,000.00 to \$75,000.00. Accordingly, you can proceed on a lifetime gifting program of undivided interests to each of your beneficiaries in the land.

Most of us do not have the 50-year life expectancy necessary to complete the transfer of the asset so there are other vehicles to employ. These include family loving trusts, limited partnerships, limited liability companies, corporations, general partnerships, and defective grantor trusts, to name a few. The general strategy involved is to convey title to this organization and then start gifting the certificates representing beneficial ownership to the intended beneficiaries at heavily discounted values.

Expense is associated with the creation of the organization and the annual transfers since very good appraisals and evaluations have to be made regarding the gifts to be made. However, in each one of these situations, you are generally able to give away up to \$1.50 to \$2.00 for every dollar of gift value. But BEWARE! The IRS has been very successful applying IRC §2035 to §2038 to those owners who retain too much control and income, with the result that all of the asset value could be included in your gross estate for estate tax purposes.



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