Tax Acts of 2012 and 2017 were Game Changers, and Portability is Crucial!

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Make sure your estate plan doesn't cause a tax headache.

The American Tax Payer Relief Act of 2012, and the Tax Cuts and Jobs Act of 2017 ("TCJA") were game changers for many farmers. As a result, your existing estate plan may now be obsolete.

In a nutshell, upon death, you may pass up to $12.92 million worth of assets free from federal estate tax. A married couple can pass $25.84 million. These are the inflation adjusted exemption amounts as of January 1, 2023.

You might think you don't have a tax problem because your farm is worth less than $25.84 million, but due to the run up in land values since the 90's, be sure to look at what your neighbors are selling for, so that you understand the "real" value of your farm ground if you died tomorrow, not the value you think it should be. Also, be aware the proceeds from life insurance policies are included in the value of your estate, and when added to the value of your farm and other assets, your family may face an estate tax bill you never saw coming. State death taxes also deserve careful consideration since some states impose significant taxes at death.

Also, the TCJA's "doubling" of the estate tax exemption is scheduled to expire or "sunset" on January 1, 2026, at which time the estate tax exemption would revert back toward the previous levels which with inflation adjustment is estimated to be $7 million per person, and $14 million for a married couple. Therefore, while you may not have a tax problem now, you could have one in 2026.

For federal tax purposes, you may give away up to $12.92 million of your assets without having to pay federal gift tax during your lifetime.

That would reduce the amount of your exemption remaining at death. The annual gift tax exclusion is currently $17,000 as of January 1, 2023, which won't reduce your $12.92 million gift tax exclusion or be required to pay gift taxes. Like the federal estate tax exemption, the federal gift tax exemption is also scheduled to revert back to around $7 million per person in 2026.

For estates or gifts in excess of this exemption, the maximum tax rate is 40%. As always, there is an unlimited marital deduction.

Also, portability of unused exemption to the surviving spouse is available. That means if your spouse dies first, leaving all assets to you, the unlimited marital deduction requires no tax at the first death and your spouse's $12.92 million may be "ported" to you. That shelters $25.84 million of your assets from tax when they pass to your children at your death.

The deceased spouse's unused exemption that is "ported" to the survivor will not receive future inflation adjustments or be impacted by the sunset of the tax act, becoming locked in at the first death. However, the survivor's exemption would continue to increase with inflation, or be reduced if the TCJA is allowed to expire.

Before portability, estate planners took great pains to help clients divide ownership of their assets, so that each spouse owned enough property to fully utilize their estate tax exemption. That is no longer necessary. In fact, it may be more beneficial to make sure all assets are owned by the surviving spouse, in order to get the highest step-up in basis at the second death, depending on the net worth of the couple.

A common mistake is for the surviving spouse to fail to "elect portability" when the first spouse dies. A Form 706 must be filed in order for the deceased spouse's unused federal gift and estate tax exemption to be transferred to the surviving spouse. It's not automatic, and it's a crucial action to take if the surviving spouse's assets are likely to be over $7M at the second death (the anticipated level of the estate tax exemption in 2026). Often no taxes are owed at the first spouse's death, and typically all the assets were jointly by husband and wife and no legal action is required at all. However, it's very important to consider filing to elect portability after the first death, would be short sighted not to seek out advice to help make this decision.

Form 706 generally must be submitted to the IRS within nine months of the first spouse's death. That deadline can be extended automatically with Form 4768, for an additional six months. If a surviving spouse missed the initial deadlines for filing, they can still elect portability up to five years from the date of their spouse's death by invoking "Relief under Revenue Procedure 2022-32." If your spouse has died within the last five years, you should consider filing a Form 706 to elect portability!

If your farm is worth more than $25.84 million, you and your spouse need to think about how your heirs will pay the 40% federal estate tax. The special use valuation under Internal Revenue Code § 2032A may allow the value of your farm to be reduced for estate tax purposes.

You should review the special use valuation metrics on a frequent basis and make adjustments to bring your estate into compliance. Also, your succession plan should be structured to make sure your heirs meet the strict compliance of the special use valuation rules after your death.

Life insurance can provide liquidity to pay the estate tax.

However, it is important for the policy to be properly owned so the death benefit is not included in your gross estate, which would only exacerbate your tax problem.

You could create an irrevocable life insurance trust (ILIT) to be the beneficiary of the life insurance policy, which would keep the insurance proceeds from being included in your estate. The ILIT can purchase assets from your estate for cash or loan money to your estate to pay the tax.

The beneficiaries of your ILIT and estate are typically identical, so shifting assets between the two doesn't change their ultimate disposition.

Proper use of withdrawal rights can allow your annual contributions to the ILIT for premium payment purposes to qualify for annual tax exclusions.

If you can't fathom one more trust as a part of your estate plan, then direct ownership of the life insurance policy by your adult children can accomplish the same estate tax exclusion. But think carefully about the associated risks it brings, such as your child's divorce, failure to pay the premium and refusing to use the proceeds to pay the tax after your death.

A member of the Farm Journal Legacy Project Advisory Team, attorney Polly Dobbs is part of a seven-generation farm family. She understands the unique issues facing farmers and succession planning.

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