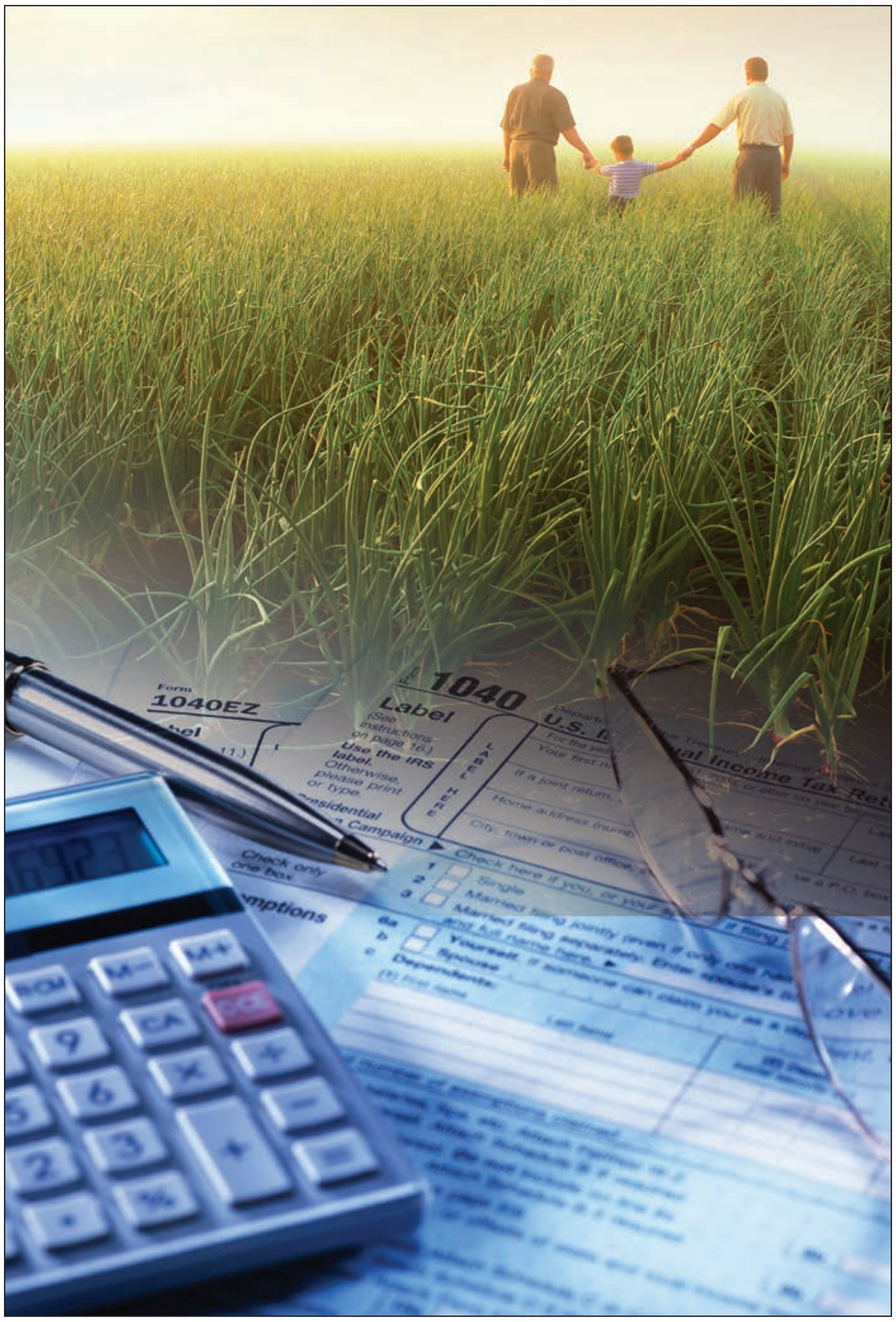
Farm Management

Navigate the sea of estate tax law



Farm & Family

By STACEY LEE

WITH income tax filing season wrapping up for many taxpayers, taxes seem to be on everyone's mind.

For those of us who live, work or own property in Minnesota, the types and amount of taxes can seem overwhelming. There is a state income tax, estate tax, sales tax, property tax and fuel excise tax, to name just a few. Most of us who are subject to these taxes want to take advantage of every planning technique, election and deduction to minimize, if not avoid, paying any unnecessary tax.

This month, I'd like to introduce you to Mr. and Mrs. Uninformed. Now, don't get me wrong. These clients are smart, successful and well-intentioned people. They simply were not knowledgeable in the ins and outs of Minnesota estate tax law. They had previously set up revocable living trusts, pour-over wills, power of attorneys and health-care directives. They knew their estate was below the federal estate tax threshold of $5,430,000 each in 2015, but had been hearing about changes to the Minnesota estate tax law and wanted to discuss the impact of these changes on their estate.

After reviewing their current estate planning documents, we needed to determine their current net worth. The clients own 640 acres of farmland valued at $3,200,000 ($5,000 per acre); no debt; retirement accounts of $1,300,000; life insurance of $1,000,000; and cash and cash equivalents of $500,000, coming up with a total net estate of $6 million. It is only after gathering this information that we could determine the potential Minnesota estate tax liability for Mr. and Mrs. Uninformed.

Overview of Minnesota estate tax

Minnesota is a state that has its own estate tax. In 2015, the Minnesota estate tax applicable exclusion per person is $1.4 million, with tax rates ranging from 9% to 16% on the amounts above the exclusion.

In other words, each person can pass through the first $1.4 million at his or her death without Minnesota estate tax liability. If you are married, you might think you could pass double the amount through without Minnesota estate tax liability, but that is often not the case. In Minnesota, the estate tax exclusion is not portable. This means you can't pass any unused exemption to your surviving spouse in Minnesota, like you are able to do for federal estate tax, which allows for portability.

This is the reason that the very common "I love you"-type wills often do not work here. When one spouse dies and leaves everything to the surviving spouse (the "I love you"-type will), the first Minnesota estate tax exclusion is essentially lost.

Fortunately for Mr. and Mrs. Uninformed, this issue had previously been addressed when they completed their revocable living trusts by including language that preserved the Minnesota estate tax exclusion upon the first death.

Without using any other deductions, upon the first death of Mr. or Mrs. Uninformed, I would likely make a qualified terminable interest property (QTIP) election, which would defer any estate tax liability on the estate amount over $1.4 million until the surviving spouse's death.

This QTIP election would allow for the surviving spouse to receive the income for life while deferring payment of estate tax until the surviving spouse's death. The details of the QTIP election are beyond the scope of this article, so let's move on to the Minnesota deduction that would fit Mr. and Mrs. Uninformed's estate perfectly.

Qualified property deductions

In 2011, Minnesota passed legislation that allowed qualifying small business and farm property owners an additional deduction to decedents dying after June 30, 2011. This deduction could not exceed $4 million. In 2013, the laws covering this deduction were adjusted and clarified.

This deduction has had a significant impact on reducing or eliminating Minnesota estate taxes for qualifying estates. The requirements for these two deductions are similar, but there are differences, such as the material participation requirement for the qualified small business property deduction.

Both deductions have the following requirements:

■ An election claims the qualifying deduction is filed with the Minnesota estate tax return for the decedent.

■ The property's value was included in the decedent's federal adjusted taxable estate.

■ The decedent owned the property for three years prior to death.

■ The property was passed to a qualified heir (family member) at death (example: decedent's parent, grandparent, spouse, child, grandchild, aunt, uncle, cousin, a trust whose present beneficiaries are all family members).

■ The heirs agree not to sell the property to anyone other than a family member for three years after the decedent's death, or else the estate and heirs agree to pay a 16% recapture tax to the Minnesota Department of Revenue.

■ The heirs must file two information forms within three years after the decedent's death verifying that the Minnesota 16% recapture tax is not due.

Qualified small business property deduction additional requirements are:

■ The property consists of trade or business property (or shares of stock or other ownership interests that are not publicly traded).

■ The decedent or decedent's spouse materially participated in the trade or business during the year ending before the decedent's death.

■ The property does not include cash or cash equivalents.

■ A family member must continue to materially participate in the trade or business for three years after the decedent's death, or else the estate and the heirs agree to pay a 16% recapture tax to Minnesota Revenue.

Additional requirements for the qualified farm property deduction are:

■ The property consists of ag land that is owned by a person or entity that's either in compliance with or not subject to the Minnesota corporate farming act.

■ The property was classified in the year of the decedent's death as either ag homestead, ag relative homestead or special ag homestead for property tax purposes. (This can be verified with the county assessor's office, as well as by looking at the property tax statements.)

■ In the year of death, the property was classified as Class 2a property — 10 acres or more used for ag purposes.

■ A family member maintains the Class 2a property classification for three years after death.

Under current state estate tax laws, Mr. and Mrs. Uninformed's farmland meets the requirements to claim the Minnesota qualified farm property deduction: The clients have owned the farmland for the past 20 years; it will pass to their children; their trusts are registered with the Minnesota Department of Agriculture and in compliance with the state corporate farming act; and the farmland is classified as ag homestead and Class 2a property.

Note there is no requirement that the children actually farm the land themselves or maintain ag homestead status on the land to utilize this deduction. A cash lease for a minimum of three years after the decedent's death would satisfy the requirements under current state law.

The state estate tax savings is essentially based on passing the $3.2 million qualifying farm property through the clients' estates with no state estate tax liability, thus saving approximately $328,000 in state estate taxes.

Even better, this deduction would bring our clients' total $6 million estate down to a zero dollar state taxable estate ($6 million estate less $1.4 million exclusion for each spouse in 2015 less $3.2 million qualifying farm property deduction). This is the reason why the state qualified farm property deduction would benefit Mr. and Mrs. Uninformed's estate should they both pass away when the current Minnesota laws are in place.

After our discussion today, maybe our clients should consider changing their names to Mr. and Mrs. Tax-Savvy.

Lee is an attorney at law and CPA with Miller Legal Strategic Planning Centers, P.A., Tyler. Email questions and comments to her at comments@millerlegal.com.