Risk and Resilience in Agriculture

Estate Planning: An Overview

By: Kathy J. Boyd , Eric A. Peterson and Norm Dalsted[1]

Introduction

Estate planning is one of the key areas of management that often is overlooked or not addressed at all until one is nearing retirement. Unfortunately, it is sometimes never addressed until death. With the large investments many Colorado farms, ranches and rural businesses have in their possession, it is imperative to plan for the distribution of the estate before someone else does it for you. Statistics indicate that only three out of ten farm/ranch estates are successfully transferred to the next generation. And only one out of the three make it to the third generation. With the current estate/inheritance laws and regulations, if planning for the future is not a high priority, your "stuff will go somewhere" but not likely where you would have preferred.

1997 Revenue Reconciliation Legislation

On July 31, 1997, both the House and Senate passed the Revenue Reconciliation bill of 1997. A number of changes were signed into law which directly impact taxpayers concerned with estate planning. The following key changes were:

1) Capital gains reduction: effective May 6, 1997, the top rate on net capital gains will be 20 percent -- an 8 percent reduction from the previous 28 percent rate. After the year 2000, the rate will drop to 18 percent for assets purchased after the year 2000 and held for 5 years.

2) Home sales reduction: the capital gain on the sale of a principal residence will be excluded from income effectively May 8, 1997. The limit is $500,000 for taxpayers filing joint return and $250,000 for single filers.

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3) Beginning in 1998, the $10,000 annual gift tax exclusion will be indexed for inflation as well as the $750,000 ceiling on special use valuation (Code Section 2032A).

4) The new family business exemption is somewhat complicated. In essence this exemption allows the estate to deduct up to $1,000,000 of the value of the family-owned business interest that you own at the time of death. There are a number of limitations and restrictions which should be discussed with an estate attorney or qualified estate planning professional.

5)Estate Tax: While the tax rates remain unchanged, the size of the unified estate and gift tax credit will be increased in the following manner:

1998	$ 625,000
1999	650,000
2000	675,000
2001	675,000
2002	700,000
2003	700,000
2004	850,000
2005	950,000
2006	1,000,000

Table 1 contains a comparison of different growth rates relative to the unified credit increase with an estate valued at $600,000 as of January 1, 1997.

Table 1: Comparison of a 4 and 6 Percent Estate Growth Rate to the Unified Credit Rates for the Period 1997-2006.

	4%	6%	Unified Credit
1997	$600,000	$ 600,000	$ 600,000
1998	624,000	636,000	625,000
1999	649,000	674,000	650,000
2000	675,000	715,000	675,000
2001	702,000	757,000	675,000
2002	730,000	803,000	700,000
2003	759,000	851,000	700,000
2004	790,000	902,000	850,000
2005	821,000	956,000	950,000
2006	854,000	1,014,000	1,000,000

*Values were rounded to nearest thousand

It is apparent that even with the increase in the unified credit rates, estate planning is still a needed element of one's personal and business planning process.

6)Lastly, the new legislation created a 20-year installment payment plan for paying estate taxes on closely held businesses including farms and ranches.

Why Estate Planning is Important

In a discussion about estate planning, it is extremely important to remember that EACH and EVERY taxpayer has their OWN estate. The value of each person's estate is determined by the type of assets they have, how they are owned and with whom. Therefore, EVERY taxpayer is entitled to legal defenses against federal estate tax. Unfortunately, these defenses are NOT automatic. Careful, determined legal planning MUST occur if a taxpayer is to benefit from the options available under the current tax codes and regulation.

Estate planning is critical to estates that are currently valued over $1.2 million. It is also essential for estates under $1.2 million where no prior planning has occurred. Current laws allow the estate to be transferred to the surviving spouse with no tax implications.

However, the surviving spouse's estate, if over $600,000 could be faced with significant estate taxes.

The two primary defenses against federal estate tax are: (1) the marital deduction (a provision which allows the first spouse to die to DEFER all estate tax due until after the death of the second - or "surviving" spouse), and (2) the Unified Credit (the ability of every individual, separate taxpayer to pass the first $600,000 of their estate with no tax). The current estate tax rates start at 37 percent and end at 55 percent. If your estate exceeds $10 million, then an additional 5 percent surcharge is added. Thus, the tax rate could reach 60 percent.

If Farmer A's share of a jointly-owned estate is valued (at his/her death) at $1,000,000, his/her share would transfer directly to the surviving spouse without any tax. If the unified tax credit ($600,000 per person in '97 - indexed up somewhat until 2006) had not been utilized, the full estate tax may be incurred by the estate when the second or surviving spouse dies. This invariably occurs if the "surviving" spouse had not done any planning.

In continuing the example of the $1,000,000 estate with no planning, it is after the death of the second spouse that the estate tax is assessed. It is critical for a number of reasons to be on top of the estate planning process. For example, Farmer A's wife dies and her share of the estate transfers directly to him free of any estate taxes. Assume the wife died in 1990 and now the $1,000,000 estate has appreciated to $1,500,000 in value due to rising land prices, etc. If nothing has been done -- guess what? IRS will become an even bigger benefactor, not your children or whoever you had desired would inherit your estate. The unified tax credit of the "surviving" spouse ($600,000) is still available, and using it would reduce the value of the estate to $900,000.

Let's say that other administrative costs (probate, legal, burial, and medical costs) reduced it another $80,000. Even if the estate is still worth $820,000, resultant taxes owed would be well over $300,000. If this was a viable farming/ranching operation, it is likely to be in severe jeopardy due to the need to pay the tax. The IRS requires that the tax be paid within nine months after the death of the taxpayer. In some cases a payment schedule can be developed (not to exceed 15 years) to pay the estate tax. The major point is most families do not have the cash or liquidity to pay the tax -- thus the survivability of the operation at the previous level is highly unlikely. Unfortunately, in numerous cases that which can be liquidated quickly is sold (such as the best land, working assets such as breeding animals, machinery or equipment) to raise cash.

This article is intended to highlight the key issues and techniques of estate planning. <u>It is strongly recommended that professionals (attorney, accountant, financial planner, insurance agent or broker) who specialize in estate planning be consulted.</u>

The cost of such expertise will be trivial relative to the estate tax your estate could be forced to pay if you don't do any estate planning.

The remainder of the article will address key points or areas one needs to address when starting the estate planning process.

Outline of Estate Planning Process

1. What are the primary objectives of the estate plan?
   a. Ensure continuity of the business.
   b. Reduce or minimize the tax.

c. Distribute the estate fairly (notice I did not say equally) to heirs.
d Ensure the well-being of grantors until their deaths.
e. Ensure favorite charity, church, or university, etc, receive some portion of the estate.
f. Other.

2. Who is on the planning team?
   a. Owner(s), family, and children.
   b. Attorney with estate and tax planning expertise.
   c. Accountant with estate planning expertise.
   d. Life insurance agent/broker with estate planning expertise.
3. What is the value of the estate?
   a. Appraisal of the asset (land, improvements, machinery and equipment, water, livestock) is necessary at some point in the planning process.
   b. The basis of the appraised assets must be determined so a taxable value can be determined.
   c. What is the amount of deductions such as mortgages (other debts).
   d. How are the assets owned — joint tenancy with right of survivorship (JTROS) versus tenancy in common.
   e. What is the business organizational form in place (sole proprietor, partnership, corporate — Subchapter "C" or "S".

The information identified in the preceding section is critical to the estate planning process. Do your homework prior to sitting down with the experts, so that their recommendations are suitable.

4. Ownership transfer of the estate.
   a. Gifting.
   b. Transfer at death.
   c. Sell the family business to a third party.
   d. Sell to an inside group
5. Gifting
   a. $10,000 per year per taxpayer per recipient — thus both father and mother can each gift $10,000 to children or whomever every year.
   b. There are benefits and disadvantages to gifting. If a single taxpayer "gives" more than $10,000 to an individual in a particular tax year, they could be using up part of their $600,000 exemption against the federal estate tax. Giving away too much of the wrong kind of assets could have an impact on the "special use" provision (230A qualification).
   c. Gift taxes and estate taxes are both considered a "transfer" tax, therefore they use the same rate schedule. Sometimes there may be an advantage to gifting instead of transferring an asset after death. For example, transferring a piece out of the estate that is rapidly appreciating can have significant benefits. The current value of the land plus all its future appreciation is now out of the estate.
   d. Applies to most gratuition shifting of property or property rights during one's lifetime.
   e. During each year, a parent or donor can give $10,000 to a child without any tax calendar consequence.
      If the donor's spouse joins in, the donee can receive two $10,000 gifts: a total of $20,000 per year.
      And, if the donee's spouse is a recipient, the maximum annual tax-free gift can jump to $40,000 each year.
   f. The value of gifts of property is the fair market value of the property on the date of the gift (it is extremely important to have an accurate, current appraised value).
   g. What happens if the donor wished to give more than $10,000 to a donee?

The donor can pay gift tax on any amount over $10,000 or
The donors can use part of the $600,000 exemption against the federal estate tax.

h. Each donor must file his/her own gift return. The gift-splitting provision under Section 2513 is validated by signing the consent on the other spouse's return.

6. Psychological issues when gifting is considered:
   a Gifts from parents often have strings attached - that is Mom or Dad are still in charge.
   b. Gifting doesn't create family heroes. (Mom and Dad struggled to build this business, and sometimes don't want the struggle totally eliminated for children.)
   c. Can make equalization planning difficult when there are "active" and "inactive" children in the family business.
   d. If the estate is healthy and growing, gifting may not cover the growth (i.e., estate is growing an average of $100,000 per year and parents can only give away $80,000 per year.)
   e. When gifting enters the transfer equation, what should be a business decision--c ontinuity and management of the business — can get confused with emotional family issues.
      - A buyout versus gifting is another approach that can be used, particularly when family issues arise.
      - "Involved" family heirs purchase business interest from "uninvolved" heirs.
      - Simplifies some of the emotional dilemma.
      - Value received can be worked into estate plan so that it is equal for all children.
      - Estate plan can be coordinated with business continuity.

7. Unified Tax Credit
   a. Each taxpayer can pass the first $600,000 of their assets during his/her lifetime or at death. UTC will increase each year starting in 1998 through 2006.
   b. If a donor saves the credit until death, the first $600,000 in assets can go to the beneficiary, Tax Free. Generally speaking, there is a federal estate tax on anything over $600,000.
      If married at the time of death, the tax can be deferred until the spouse's death.
   c. Thus, if a married couple plans carefully, they can give away up to $1,200,000 (using both exemptions) during their lifetime or at death - with no estate tax due. Some taxpayers use part of their $600,000 exemption during their life to pass some kinds of assets at death.
      In addition, an individual tax payer can transfer up to another $1,000,000 in assets through generation-skipping devices.
   d. Many planners recommend using the $10,000 annual gift exclusion but no more; so the donor does not have to **file** a gift tax return. This saves the entire $600,000 exemption until death.
      - Why might it be better not to pass some assets during a taxpayer's lifetime? Anytime a donee receives a gift from a donor that is living, the donee also "inherits" the donor's "basis" in the asset i.e. - a father gives his son 100 acres pasture land that is now worth $4000 per acre for a housing development. The father paid $100 per acre when he bought it in 1960. If the father had sold the land, he would have paid a 28%

capital gain tax on $3900 per acre. If the son sells the land after it is given to him by his father, while his father is alive, he will pay the capital gain tax too.

- On the other hand, if he inherits the ground at his father's death, he receives a "step-up" in the tax basis. The son inherits the ground at its current value - he can sell it a week later for $4000 per acre and incur a small amount of capital gains tax.

e. Another approach is to give more than $10,000 — so in fact the donor will need to file a gift tax return. Why? The reason is to build a valuation history. By filing gift tax returns and paying modest gift taxes, the donor establishes a record of appraised values, the various factors that influenced the value, and the valuation methods IRS found appropriate at the time of the gifts. (Can be important when gifts of stock in the family business are transferred.)
For example:
Another transferred one share of stock from the farm/ranch business valued at $12,000 to her daughter each year for three years using the $10,000 annual exclusion each year. At 37 percent the gift tax each year is $540. Assume IRS audits two of the gifts and agrees on a value of those gifts and agrees on a value of those gifts at $13,500. The mother would have to pay an additional $1,110 in gift tax. But after her death IRS will find it difficult to argue that the value is substantially more.

f. The 1990 Tax Act starts the statute of limitations running even when gifts are deemed to be nontaxable (i.e., less than $10,000). The donor should disclose the transaction to IRS in a statement attached to gift tax return (which will then begin the three-year period that IRS has to challenge the value of the gift).

8. Using the $600,000 today or in the future.
   a. Three reasons for addressing this question:
      1) There is no guarantee that the $600,000 unified tax credit will be available.
      2) The present value of the $600,000 exemption is higher today than in the future. The $600,000 exemption is fixed but the value of the estate is appreciating each day. Consequently, the exemption covers less and less of an estate's value.
      3) Removing a $600,000 asset from the estate today provides a double benefit. Future growth of this asset if removed from the estate. reduces the estate tax in the future.
   b. For example: A $600,000 gift today at a 6% appreciation rate results in a value of $2,000,000 twenty years down the road. Thus, using the $600,000 gift today prevents $1.4 million future value from being subject to estate tax.
   c. Because of capital gains taxes, asset appreciation, losing control, estate taxes on assets left in the estate, and a host of other issues - it is imperative that taxpayers consult with a trusted team of professionals who can weigh all the alternatives and come up with recommendations that fit the taxpayer's individual situation.
9. Capital gains
   a. Currently if you are 55 or older and sell your home you may not have to pay tax on all or part of the gain up to

$125,000 ($62,500 if married filing separately) even though you do not invest in another home.

b. Remember this exclusion will be part of the value of your estate, unless you happen to spend the gain before you die.

10. Transfer Mechanisms - there are four primary transfer mechanisms. The four covered are wills, trusts (revocable and irrevocable) and family limited partnerships.

ESTATE INSTRUMENTS

With the permission of Mr. Eric A. Peterson, an attorney specializing in Estate and Transfer Planning, with the firm of Liggett, Smith, and Williams, Fort Collins, Colorado, the following information is presented:

WILLS

What are the names and hometowns of your spouse, adult children, and parents?

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What are the names and dates of birth of minor children?

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Do your beneficiaries have normal health, life expectancy and ability to manage their finances? If not, explain your concerns.

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Do you own land or mineral rights outside Colorado? If so, you may want to look at a revocable living trust or family limited partnership as part of your estate plan.

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Do you have any specific assets that you need to designate for certain beneficiaries? If so, explain.

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A will can minimize estate taxes without too much adverse effect on how you give away your assets, in many cases. For married people, preventing estate taxes on the first $1.2 million of assets is not difficult.

What is the best estimate of the fair market value of your assets? ______________

Remember to count personally-owned life insurance at face value, retirement plan benefits and the entire value of assets in joint tenancy with children (unless they have money invested in the accounts, too).

How much interest and capacity does your spouse have when it comes to finances?

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Would your spouse want to be trustee for a tax planning trust?__________________________

Are charitable gifts something you're interested in? If so, explain.

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Sometimes, the goals of treating children equally, yet giving the family business to one child can be met by careful will provisions. Other times, you need life insurance (usually held in an irrevocable trust), partnership arrangements (to give the other children economic benefits and to give the one child who can run the business the control) or a buy-sell agreement (usually featuring insurance on the parents owned by a child or children) to tie in with the will.

Who do you want to have handle your estate as personal representative?

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And a Backup?__________________________
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Who do you want to handle funds for minor children as your trustee?

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And a Backup?__________________________
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Who do you want to inherit your estate if neither your spouse nor any of your children survive you?____________________________

Are there any charities to which you wish to make a gift?

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If your estate is pretty large ($1.2 million or more) is there any part of it that you want to use for **specific** gifts to friends, or others, who have meant a lot to you during your life (while leaving most of your estate to your kids)?
If so, explain.

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If you have minor children, a will addresses their upbringing.

Who do you want to be guardians for your children until each is 18?

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And backups?____________________________
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What kind of guidelines do you want for the trustee when it comes to distributions for the children? Explain.

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What about paying for a car? Encouraging the beneficiaries to get work to pay for some of their expenses? Making distributions in stages until the children are 30?

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Wills usually cost less than revocable living trusts to prepare . When they try to include tax-planning arrangements, there must be some review of how your assets are titled (joint tenancy assets are re-titled as tenancy in common or solely owned assets). Also, insurance beneficiaries are often changed to make proceeds payable to the estate of the insured. Retirement plans left "in the estate" can be very costly - subject to income tax at death plus estate tax (if estate is large enough to be taxable).

Wills don't cover asset management if you're disabled. Therefore, you need powers of attorney for financial and health care matters, Who would you count on to be your agent?

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And a backup?_________________________
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TRUSTS

1. A revocable living trust (RLT) can also distribute assets and more. It provides for management of your assets while you are alive (if you need this) and transfer of assets after you die without any involvement in the probate system. Trusts generally cost more, and take more paperwork to set up and operate. Whether you benefit overall depends on your answers to these questions:

Is your estate over the $1.2 million taxable threshold?_____________________________

Do you own land or mineral rights outside of Colorado?_____________________________

Do you plan to reside outside of Colorado?

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____

Do you want professional management (i.e., by a bank or other trust company) for part or all of your assets?

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Do you have a health condition that is going to make it difficult for you to manage your own assets in the reasonably near future?

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Is it important to you that few people know who your beneficiaries are?__________________

Will the benefit of a RLT justify the added set-up costs?_____________________________

A "yes" answer to any of the questions above points to a possible use for a revocable living trust.

2. Revocable trusts can help in reducing estate taxes, when compared to wills, as they allow the first spouse (who dies) full use of their "$600,000 exemption".

3. A revocable trust offers no real protection from creditor claims for the assets held in trust. This is a common misconception. An irrevocable trust protects your assets, if set up properly (because you no longer have any control of the benefits yourself), but that's a different legal arrangement.

4. Unlike doing a will, setting up a trust requires that your attorney have a complete, accurate, detailed list of all of your assets. This includes titling information.

   What is the correct legal description for each parcel of real estate you own?
   ____
   ____
   ____
   ____
   ____
   ____

   How is each owned (i.e., Just your name? Yours and your spouse?) Tenants in common? Joint tenancy with "right of survivorship?
   ____
   ____
   ____
   ____
   ____

   What is the account number and title for each CD, securities account, partnership or other investment you have?
   ____
   ____
   ____
   ____
   ____

   What life insurance pollicies and annunities, IRA accounts, 401(k) plans, or other qualified plan accounts do you have? How will these policies, accounts, etc. affect the settlement of your estate?
   ____
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   ____
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5. For an estate plan to be complete it should include "pourover" wills, powers of attorney with trust transfer powers, tangible personal property lists, health care powers of attorney, and transfer documents (such as deeds, assignments, beneficiary change forms, etc.).

   See the worksheets for information that you'll need to complete for your attorney.

IRREVOCABLE TRUSTS

1. An irrevocable trust helps the person setting it up ("Grantor" or "Settlor") save income or estate taxes or both. Since it never serves as the basic technique to transfer assets, it can be viewed as an add-on, after the basic plan is in place.

2. An irrevocable trust can hold gifts for children. Often insurance is owned by an irrevocable trust, so that it is not part of the taxable state.

   Do you have an estate large enough to cause estate taxes even after tax-planning is in place? That would be over $600,000 for a single person, over $1.2 million for a married couple now? Or over the scheduled indexed amounts in the future?

   Are you insurable?___________________

How about your spouse?______________

Do you want your children to receive an inheritance diminished as little as possible by death taxes?______________________

Do you need or want to "even up" gifts among your children?________________

3. An irrevocable trust can be used to hold gifts for grandchildren. This is a "§2503"(c)" trust. It ends when the beneficiary reaches age 21. Each grandparent can put up to $10,000 per year into a grandchild's trust. Probably neither grandparent nor the child's parents should be trustee (use an aunt or uncle or trust department).

4. An irrevocable trust can hold gifts for a charity.

   Do you have assets to put in the trust that have a basis much lower than their fair market value? If so, explain.

   ____
   ____
   ____
   ____

   Do you receive a low rate of return on these assets and want to improve it?

   ____
   ____
   ____

   If there is a charity (or group of them) you'd like to benefit at your death? If so, explain.

   ____
   ____
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   If the assets in this trust go to the charity when you're gone, do you want to replace the value of that gift to your children?

   ____

FAMILY LIMITED PARTNERSHIPS

1. A family limited partnership carries out three important functions in the transfer of assets among family members. First, the arrangement makes gradual transfer easy, through a series of simple, annual gifts. Second, it allows the senior family members to retain control even if they own as little as 1% of the property! Third, because partnership interest is relatively aliquot, the IRS allows substantial discounts on the value of property owned by the partnership. Consequently, there are gift and estate tax benefits of going this way.

2. Similar organizational and tax benefits can be achieved through a limited partnership (LP), limited liability company (LLC), or limited liability partnership (LLP). All are neutral business entity forms for income tax purposes. They offer tax benefits with fewer income tax and control complications than family corporations.

   Do you have a family business which includes valuable assets (such as land)? If so, explain.

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   ____

How fast are the assets growing in value? What are they worth now?

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Do you plan to bring your children into the business? If so, explain.

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Who do you see as the controlling family member(s) when you are gone?

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What are the circumstances of the family members who would be partners?

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Do you want to include grandchildren?__________________

Are there any debts on property that would go into the partnership? If so, explain.

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Do you want to give the younger partners any vote in the business operations? If so, explain.

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3. Theoretically, family limited partnerships can protect the personal needs of the partners from liability and from creditors of the partnership. Realistically though, requirement for personal guarantees to lenders can minimize the benefits.

4. The documents needed to set up a family limited partnership include the following:

   - Limited Partnership Agreement
   - Registration documents (Secretary of State)
   - Transfer documents (to place assets into the partnership)
   - Tax identification number application
   - Assignment documents (to make gifts of fractional interests)

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